

## **Ofgem Supply Market Probe Consultation Addressing unfair price differentials**

### **Written response submitted on behalf of the Government's Fuel Poverty Advisory Group for England (FPAG)**

FPAG welcomes the opportunity to respond to Ofgem's consultation regarding the addressing of unfair price differentials.

#### **FPAG Context**

- **Fuel Poverty Figures.** FPAG estimates some 4 million plus households in **England** to be in fuel poverty as at September 2008. This compares with 1.2 million in 2004. Meanwhile, average domestic dual fuel bills (Gas & Electricity) have increased from £572 to £1,287 (+125%!) between January 2003 and September 2008
- **C. 4M in fuel Poverty.** Of the estimated 4 million fuel-poor households in **England**, over 50% are pensioners and overall some 80% can be categorised as vulnerable.
- **Non gas areas.** Some 2.1M homes in **England** do not have mains gas, of these circa 630,000 (30%) are fuel poor customers; **no** dual fuel discount and exacerbated by space and water heating costs using kerosene or LPG being respectively 60% and 100% higher than those for mains gas.
- **Prepayment meters.** 14% of prepayment meter users are fuel poor (2006 data) – this represents 19% of fuel-poor households. It should be noted that latest monitoring data from Ofgem (September 2008) show prepayment installation for debt recovery at a current rate of 1,060 per day. Of households within the lowest income decile, 22% use prepayment.
- **Standard Credit.** 16% of standard credit customers are fuel poor (2006 data) – this represents 46% of fuel-poor households. Of households within the lowest income decile 44% use standard credit.
- **Conclusion.** The majority of fuel poverty customers are adversely affected, over and above very high fuel prices, by the findings of Ofgem's 'Probe'. The potential for the numbers of pre-payment customers to significantly increase, following this winters period of very high bills and credit crunch, are also further and serious causes for concern.

FPAG's response follows the sequence of questions as published in the consultation document.

## **CHAPTER TWO:**

### **Question 1: In proposing action, are the overall aims we set out appropriate? Are there other issues we should focus on in taking a decision on the best way forward?**

FPAG is in broad agreement with the overall aims and objectives of the proposals subject to the following points.

- FPAG has some concern about regulation stifling innovation and competition and suggests consideration be given to a different approach for new entrants.
- FPAG believes OFGEM should be required to consider social and environmental issues. FPAG remains very disappointed with Ofgem's apparent satisfaction with Supplier's recent moves regarding prepayment tariffs. The implication of this is that until smart metering is eventually rolled out, prepayment customers will continue to pay significantly more compared to a customer paying by direct debit. Although it is recognised not all fuel poor customers pay by prepayment, a disproportionate number of households in the lowest income decile (22%) pay for their fuel in this manner.

### **Question 2: What is the appropriate approach to cost allocation?**

FPAG's assumption is that the inherent unfairness the Probe has identified will be eliminated from the market and that the first phase of this process will involve the genuinely cost-reflective pricing of the energy content of customer's bills. The cross subsidy between 'in' and 'out' of area customers and the disadvantage endured by electricity only customers will be eliminated.

FPAG's expectation would be for a rebalancing of tariffs to reflect their true cost to serve. However, with regard to prepayment, the smart meter cost to serve scenario should now be deployed in advance of the roll out as detailed in question 3.

Supplier's cost to serve should be an explicit amount and shown separately on customers bills. This transparency would provide further incentive on Suppliers to reduce their costs and also act as an aid to a customers buying decision when faced with a door step/ telephone sales etc sales proposition.

**Question 3: Are social or environmental issues appropriate to consider in relation to objective justification? How might these exceptions be captured in either licence conditions or guidelines?**

FPAG believes OFGEM should be required to consider social and environmental issues.

Although it is recognised not all fuel poor customers pay by prepayment, it must be recognised that there is a correlation between low income, fuel bill problems and prepayment meters use (see earlier comment on prepayment meter installation and debt). . FPAG has been consistent in its view that it is inequitable that the generally poorer consumer should have to pay more because they use prepayment meters. The majority, who do so, do it to enable them to budget and not get into debt. There is therefore a significant benefit to Suppliers of the avoided cost of debt. Furthermore, it is inequitable that due to previous regulatory intervention - competition in metering, plus governments own intervention into the smart metering agenda, prepayment customers should be denied the financial benefits of smart metering for several more years.

As a result of these interventions and the market uncertainty this has created prepayment customers will continue to pay more despite technology being available now that would resolve, to a large degree, the current tariff differential. In view of the smart meter mandate and the potential for some customers having to wait up to 10 years or more, FPAG asserts that this is now an overwhelming case for the tariff differential to be addressed and tariffs levied relative to the same relativities of a smart metering regime, as if it were in place. This could be achieved through a consistent approach to metering cost allocation, the required licence condition and based Suppliers business cases that support the roll out of smart metering. It would also act as a stimulus to address the most cost effective areas of the market first.

FPAG welcomes the move by suppliers to introduce social tariffs. Inevitably, some of these social tariffs will not be cost reflective. FPAG therefore recognises the potential implication of a regulatory requirement having a perverse impact on our aspiration for improved social tariffs. One conclusion from such a context is that Suppliers social tariffs are not therefore an act of social justice or corporate philanthropy but merely come about through cross subsidy.

Although social tariffs are not explicitly part of the probe, FPAG asserts it is now the right time to level the playing field for all suppliers and declare a properly mandated social tariff. FPAG asserts that Ofgem should mandate a Social Tariff explicitly funded through a Fuel Poverty Levy (FPL) on all MWhs and Therms sold. FPAG understands that his approach is now supported by some Suppliers. Such a move would level the playing field for all major suppliers who currently

have different levels of fuel poverty from their latent and legacy customer base. This drives the current inconsistency of offering and tariff withdrawal when particular limits are reached. The fund would be synchronised to market volatility and be distributed to the most in need as identified by DWP and credited by Suppliers directly to energy accounts.

This fund could also be used to assist those who, through current and past regulatory regimes, will never be able to have access to mains gas. Circa 30% of current fuel poor customers do not have mains gas.

FPAG believes OFGEM should, through licence conditions, make the financial implications of environmental issues such as Green tariffs – feed in tariffs – CERT (and its successor) explicit to customers. FPAG believes this transparency would create an incentive for suppliers to drive down their costs and also stimulate competition. For example, the current notional amount for CERT and its regressive nature should not be buried within current tariffs. Customers are entitled to know what they are paying for. OFGEM is well aware of the current proposals being debated regarding further energy efficiency measures and environmental initiatives which are likely to increase the current level of CERT through its successor. Furthermore, the existing 20% increase in CERT together with the Prime Ministers expectation that this cost will not be passed onto customers is a vain hope without the proposed level of transparency.

**Question 4: Would it be beneficial to give a clear indication of materiality thresholds either on the face of any licence conditions or in guidance?**

FPAG is of the view that any continued breach of fair pricing arrangements is unacceptable but accepts that marginal grey areas are not conducive to regulatory action. However, given that Ofgem distinguishes between general marginal unfairness and that with consequences for vulnerable consumers, FPAG would expect to see vigilance on the part of the regulator to prevent any significant drift and strong guidance to suppliers on the need to avoid disadvantage to vulnerable customers.

Where relative price controls have been used in the past it has been for the Supplier to demonstrate that they are not in breach by making a standardised submission to the regulator; this approach would seem a reasonable way to monitor and manage the proposal.

**Question 5: Would it be beneficial to introduce a new enforcement process? If so, should this process be of the form set out in this document? Are there any other considerations in relation to the detail of how such arrangements might work?**

There will have to be some form of enforcement process to give confidence that regulations are being adhered to. FPAG is of the view that a new process needs to be adopted in order to bring about the necessary rigour and, through Suppliers

risk management controls, the necessary executive oversight to this new requirement. The process as set out in the consultation would seem appropriate

**Question 6: Should the proposals for licence requirements set out in this document apply to all suppliers active in the market for domestic consumers - or only to a subset of these suppliers, such as the Big 6?**

FPAG is of the view that sustainable product innovation for fuel poor and vulnerable customers has, to some degree, been very limited from the big 6 suppliers. (It is acknowledged that social tariffs have made progress but our issues with these remain). Meanwhile, some small suppliers have built their creative propositions across all demographics but their impact on the market remains limited. FPAG is therefore, of the view that whilst regulation needs to be proportionate, it suggests Supplier customer number thresholds e.g. 100,000 customers be determined for attendant levels of regulatory reporting and oversight. In doing so this would continue to enable new entrants to be creative and potentially encourage other new entrants, who it is judged would appear to have the least opportunity to cross-subsidize.

**Question 7: Would a sunset clause be appropriate for any licence conditions? What would be a suitable time period before any review of the market?**

Inevitably a sunset clause has to be sufficiently far into the future to be sure the regulations have had some effect. However, in view of the 10 years it has taken to determine the current problems, the ongoing market volatility and dramatic changes planned with smart metering and other environmental initiatives, a sunset clause would seem inappropriate.

**CHAPTER THREE:**

**Question 1: What are the relative merits of each of the proposals for licence requirements?**

**Proposal A: Cost-reflective pricing between payment methods**

**Proposal B: Prohibition of undue discrimination**

**Proposal C: Relative price controls**

**Proposal C: Prohibition of 'cross subsidy' between gas and electricity supply**

All of these proposals will contribute in some way to the elimination of unfair price differentials.

**Proposal A**

**Question 2: How would we best apply such a condition in order to minimise concerns over regulatory uncertainty and risks to competition and innovation?**

The identification of the real costs of payment methods is an essential first stage in eliminating unfairness but must be supplemented by other actions. The requirement for suppliers to show separately consumers bill their cost to serve and a price per Kilowatt hour should not give rise to regulatory risk and or uncertainty. FPAG does not support Ofgem's view that this proposal could stand alone without any of the other options.

**Proposal B**

**Question 3: How would we best apply such a condition in order to minimise concerns over regulatory uncertainty, and risks to competition and innovation?**

The proposed licence condition simply merges legitimate cost reflectivity relating to both payment method and geographical location. FPAG judges these proposals as a minimum criterion in a 'fair' market. However, FPAG would distinguish between 'good' and 'bad' discrimination in recognising that social tariffs should be exempt from cost-reflective criteria if a mandated approach was not adopted.

In a non mandated social tariff context, Ofgem's concern about consumers not lose out through their inability to access particular tariff deals through access to certain payment methods or where they live' raises some difficulties in relation to social tariffs. Not only will social tariffs have to be exempt from discriminatory criteria they will also have to be accessible to all households meeting the relevant eligibility criteria rather than, as currently happens, being subject to some form of predetermined quota system.

FPAG's advocacy of a mandated social tariff should not have implications for competition and nor should the proposal to adopt the smart meter prepayment cost to serve scenario in advance of its deployment.

**Question 4: Are there other non-price issues we should specifically seek to take account of?**

No Comment

**Question 5: Could this sort of prohibition be used to address instances of cross subsidy between gas and electricity supply – or would an additional condition, such as an explicit prohibition on cross subsidy, be needed to address this issue?**

This model licence condition could be used to adjust unfair charges made to electricity only customers. FPAG sees no substantive reason why the prohibition should not apply to this issue since the phrasing of the condition (includes but is not limited to) appears to comprehend all categories of domestic customer.

### **Proposal C**

#### **Question 6: How would we best apply such a condition in order to minimise concerns over risks to competition and innovation?**

FPAG believes, although mindful of competition and innovation, Ofgem's priority to be the elimination of unfairness to, and protection of, fuel poor, vulnerable and rural consumers, many of whom are off the mains gas network. This should, in view of the Probes current findings, take priority over any perceived threat to competition and impact on innovation. There is also the opportunity to reduce regulatory burden to new entrants as outlined in Chapter 2 question 6.

#### **Question 7: Which price differentials should be covered by relative price controls?**

FPAG sees no justification to exclude any differentials from relative price control. Both tariff and geographical disparities should be subject to price control.

#### **Question 8: How would we define the relevant benchmark tariffs by payment method and by geographical area?**

In the consultation document it implies that all tariffs, except for the 'benchmark' tariff, would be subject to price control and, given that it is indicated that the benchmark tariff would be the lowest, FPAG's assumption is that online direct debit would represent the benchmark in most cases.

The case for geographical variation is generally weak and, contrary to all notions of fairness, the major issue of concern has centred on unreasonable treatment of in-area customers and particularly those in non gas areas. There may be a marginal justification for pricing disparities in some regions but FPAG would expect this to be minimal.

FPAG is surprised that Ofgem prejudices issues of differentials in suggesting that, in relation to direct debit, the premium for prepayment will be higher than for standard credit. Clearly this is not currently the situation with at least one energy Supplier.

#### **Question 9: Would 3 years be a reasonable length for each price control period to last, after which time we would look to reset the differential limits (or should there be a firm sunset clause)?**

FPAG judges a three-year period as reasonable. Ofgem should retain all options while assessment is made of the consequences of the price control thus ruling out any notion of a sunset clause.

**Question 10: Under what circumstances should we allow the price controls to be re-opened?**

FPAG does not consider such a specification to be neither helpful nor necessary.

**Question 11: How would we take into account different consumption levels? Should the limit in relation to payment methods be expressed in a way that avoided the amount charged varying with consumption?**

FPAG believes payment levels should be irrespective of consumption levels. For any differential to be cost-reflective it should, in theory, impose a charge no less and no greater than what is actually justified. In effect this would represent a standing charge but without the mechanism to collect it and particularly so for prepayment customers.

**Question 12: Would a revenue cap be preferable to a relative price cap?**

FPAG sees no particular case for, or benefit from, a revenue cap based on payment differentials. The fundamental issue of customer equity would remain. However, in the context of a linear regression model approach whereby all Suppliers costs to serve were plotted for different tariff types and an efficiency frontier for each determined, this would have significant merit if a revenue cap on cost to serve was then calculated. It would also expose those Suppliers who do not appear to ensure some costs are efficiently incurred. This approach is worthy of further and serious exploration.

**Proposal D**

**Question 13: Are there alternative ways to address the sustained high margins earned on single fuel electricity customers?**

Yes. FPAG's assumption is that the inherent unfairness the Probe has identified will be eliminated from the market and that the first phase of this process will involve the genuinely cost-reflective pricing of the energy content of customer's bills. FPAG is, however, surprised at the tone of the proposed licence condition. In the absence of any data that would give FPAG any anxiety to the contrary we judge 'best endeavours' as unacceptably weak in describing the responsibilities of energy suppliers to domestic consumers and, similarly we believe that 'sustained period of time' and 'significantly greater gross profit margin' are inappropriately vague in such a formal document.



**Question 14: Should we specify what represents a "significant implicit cross subsidy" or, as we have proposed, rely on the principle of materiality in order to decide?**

Since the principle of 'materiality' is defined by Ofgem (at 2.8) as 'substantial, extensive and persistent' it is difficult to see how some objective indicator(s) can be avoided. However, given that the regulator wishes to avoid stipulating materiality thresholds for fear of encouraging persistent low levels of offence it is difficult to follow Ofgem reasoning.

**Question 15: Would it be appropriate, as we have proposed, to introduce a reciprocal condition to deal with potential cross subsidy of electricity supply from gas supply?**

Since the initial condition is confused it is difficult to answer this question.

## APPENDIX TWO:

**Question 1: What are the potential impacts of the proposals set out in this document? Where possible, please indicate the magnitude of any impacts.**

FPAG is unable to give a detailed response.

**Question 2: What are the potential impacts on consumers of these proposals?**

Subject to FPAG's proposals being adopted the proposals may mean an increase in price to some customers, but across the board they should be beneficial and equitable.

**Question 3: What are the potential impacts on competition of these proposals? What are the potential impacts on small suppliers?**

Subject to FPAG's proposals being adopted the proposals competition should be enhanced and may also facilitate greater creativity from both large and small suppliers

**Question 4: Would these proposals have a significant impact on sustainable development? In particular, is there anything in the proposals that would preclude the development of green tariffs, energy services offerings and similar innovations?**

FPAG does not believe there would be an adverse impact on “Green” offerings since in order ‘to be green’ these products should be at a premium already and in which case the customer has made a conscious decision to pay more for a green product.

**Question 5: What are the potential impacts on health and safety of these proposals?**

FPAG is unable to give a detailed response.

**Question 6: What are the risks and potential unintended consequences of these proposals?**

FPAG is unable to give a detailed response.

Derek Lickorish, FPAG, Chair  
21<sup>st</sup> February 2009