Campaigning for Warm Homes

Ofgem Consultation on Addressing unfair price differentials

Response from National Energy Action (NEA)

Background

Fuel poverty in the United Kingdom currently affects some 5.4 million (1 in 5) households. Data relating to England suggest that rising energy prices post-2003 are responsible for the appalling increase in the scale of fuel poverty from 1.2 million households in 2004 to almost 4 million in 2009. There are some indications that the period of relentless increases in gas and electricity prices may be over with some suppliers introducing modest reductions in domestic energy bills. Nevertheless, the Government's UK Fuel Poverty Strategy[1] has been comprehensively wrecked with the 2010 target unattainable and little prospect of the 2016 target being met.

In this context it is essential that Government should ensure that the contributory factors in fuel poverty: poor heating and insulation standards; low household income; and unaffordable energy prices should be addressed with the utmost urgency. NEA therefore welcomed Ofgem's Energy Supply Markets Probe for its potential to analyse and resolve problem areas of the competitive market as it affects disadvantaged energy consumers.

However, while welcoming Ofgem's scrutiny of these areas, NEA takes the view that market failings had long been identifiable and that the regulator has been remiss in permitting these failings to become entrenched across the industry. However, belated action is clearly better than continued inaction and NEA is hopeful that the outcome of this consultation will be to the benefit of low-income and other vulnerable households.

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

Chapter 2

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 to proceed in this matter?

The overall aims as set out in the introduction are to be commended. NEA particularly welcomes Ofgem's recognition that protecting the interests of vulnerable consumers is a primary concern; that this is not always best achieved by competitive markets; and that regulatory intervention will be required to eliminate unfairness.

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[1] The Strategy sets Government targets to end fuel poverty for vulnerable households in England by 2010 and for all English households by 2016.

We are less reassured by the implication that action to constrain unfair pricing might be compromised by the wish to avoid any hindrance to innovation or development of competition. The principle of fairness must be paramount in any market for essential services and, NEA would argue, fairness needs to be understood as a more comprehensive objective. Absence of unfairness in the operation of the market should be supplemented by action on energy prices to promote access to wider social fairness and equity.

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

NEA's view of the Energy Supply Market Probe was predicated on two assumptions (a) that the market was inherently unfair to some disadvantaged customers and (b) that even if there was no intrinsic unfairness there remained a need for remedial action to improve the circumstances of some vulnerable households. These views remain constant.

Our assumption is that inherent unfairness will be eliminated from the market and that the first phase of this process should involve an impartial and rigorous analysis of 'cost to serve'. Our expectation would be for a rebalancing of tariffs to the advantage of standard credit and prepayment customers with some possible detriment to conventional and/or online direct debit customers. In order to ensure equity and to encourage efficiencies across the industry, any identifiable prepayment surcharge should be discounted to achieve parity with standard credit. Where standard credit attracts a surcharge NEA would expect to see that payment method equated with prepayment.

It should be noted that the social benefits of such an approach will be modest and that additional measures will be required to assist vulnerable households through revised tariff structures. Clearly the regulator does not see this requirement as part of the consultation exercise but it is an issue that NEA will return to in discussing the role of social tariffs.

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?

Social issues are certainly appropriate for consideration and NEA sees this issue as relevant to a brief discussion of social tariffs. NEA has commented on numerous occasions on the inadequacy of voluntary social offerings made available by suppliers including social tariffs as defined by Ofgem. Despite the limited remit of this consultation NEA would reiterate the view that social tariffs should be consistent in value and eligibility criteria, that suppliers should not impose an arbitrary ceiling on access to such tariffs and that the design of a standard social tariff should be a matter for Government. In the current, and probably future, political climate such a measure could only be funded by distributing the cost across the entire customer base.

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?

The question illustrates how Ofgem insulates itself from the fuel poverty debate. Ofgem still sees the competitive market as sacrosanct and any measures that are perceived to impact significantly on the operation of the market will be deemed disproportionate. NEA concedes that this has always been the regulatory priority and that Government prescription will be required as a catalyst for action.

In principle NEA would see <u>any</u> continued breach of fair pricing arrangements as 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, NEA 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.

<u>Chapter 3</u>

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

Clearly all four options can contribute to the elimination of unfair price differentials and NEA will consider these in turn, but not without reiterating our concern and regret that action to address unfairness in the energy market has been so dilatory. The pursuit of fairness (both as a neutral prerequisite and as wider affirmative action) is long overdue and remedial action is required to balance and redress the additional disadvantage experienced by vulnerable energy consumer over the lifetime of competitive energy markets.

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?

Cost reflective pricing, or at least identification of the real costs of payment methods, is an essential first stage in eliminating unfairness but must be supplemented by other actions. NEA notes, but rejects, 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 the concept of cost reflectivity relating to both payment method and geographical location. Again, NEA would see these proposals as a minimum criterion in a 'fair' market. However, we would distinguish between 'good' and 'bad' discrimination in recognising that social tariffs should be exempt from cost-reflective criteria.

Clearly the regulator's concern to ensure that: 'consumers [do not lose] out through their inability to access particular tariff deals as a result of their personal circumstances, such as 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.

NEA's advocacy of a standard social tariff may well have implications for competition but we do not view this in the same negative light as the regulator.

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

Given NEA's support for a meaningful and consistent social tariff it would be useful if the regulator were to consider a mechanism to ensure equitable distribution of costs and responsibilities across an eligible vulnerable population of energy consumers.

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?

Clearly this model licence condition could be used to adjust unfair charges made to electricity only customers. We see 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?

NEA suggests that Ofgem focus on eliminating unfairness and protecting vulnerable consumers as a first principle. Ofgem's responsibility to protect the interests of rural consumers, many of whom are off the mains gas network, should take priority over the any perceived threat to competition and seems unlikely to have any noticeable impact on innovation.

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

NEA sees no reason 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?

As implied in the consultation document, 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, our 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. There may be a marginal justification for pricing disparities in some regions but NEA would expect this to be minimal and for exploitation of in-area customers to be the priority. We are also surprised and disappointed at the apparent willingness of Ofgem to endorse an automatic premium on in-area customers and question both the economic justification for this and, indeed, the regulator's motivation.

NEA is surprised that the regulator sees fit to prejudge 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 and we assume that this will not be an issue for regulatory intervention.

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)?

A three-year period appears reasonable. The regulator should retain all options while assessment is made of the consequences of the price control. This is particularly important in light of the later question on unintended consequences.

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

As indicated above, NEA sees no reason for the regulator to surrender powers once adopted and until it is incontrovertibly clear that they serve no purpose.

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?

For any differential to be cost-reflective it should, in theory, impose a charge no less and no greater than what is justified. In effect this will represent a standing charge but without the mechanism to collect it. Consequently we would expect any premium to be collected through a modest levy on the first (X)kWh. It seems unlikely that any fuel-poor households would be disadvantaged by such a process.

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

NEA sees no particular case for, or benefit from, a revenue cap based on payment differentials.

Proposal D

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

As the regulator points out the high margins obtained on electricity supply as opposed to gas are not a permanent feature of the energy market. Reversal of this circumstance would presumably be of benefit to rural customers and others off the gas network. However, in the interests of a fair market it is preferable that this element too should be cost reflective and NEA supports the proposal in principle. We are, however, surprised at the tone of the proposed licence condition. We see ‘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. NEA suggests that Ofgem define what represents a significant implicit cross subsidy.

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

Since the initial condition is shrouded in confusion it is difficult to answer this question. However, once the nature of unacceptable cross subsidy is identified it is inevitable that there be identical provision across both fuels.