Ofgem Consultation: Addressing unfair price differentials

Transact Response

February 2009

About Transact

Transact is the national forum for financial inclusion, a movement of over 1,300 organisations and individuals dedicated to practising and promoting financial inclusion. Our members include advice agencies, banks, community and voluntary organisations, funders, central and local Government, housing providers, third sector lenders, policy makers, private companies, social enterprises, training and employment agencies, as well as individuals interested in financial inclusion.

Transact is an initiative of Toynbee Hall. Toynbee Hall produces practical innovative programmes to meet the needs of local people, improve conditions and enable communities to fulfil their potential. For more information on Transact, please visit www.transact.org.uk.

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To find out more about Transact's pre-payment meter campaign, visit www.transact.org.uk/ppm.

Introduction

Transact, the national forum for financial inclusion, is responding to this consultation based on feedback received from its members on a range of issues relating to vulnerable consumers. In particular, Transact is concerned about the "poverty premium" being levied on pre-payment meter (PPM) users, who pay on average £215 more for their energy than direct debit customers[1].

The premium for using PPMs disproportionately affects poorer people – who are far less able to afford it. Consumers are up to three times more likely to use a PPM[2] if they are unemployed, in receipt of other state benefits, disabled or a single parent. Social housing tenants are also at high risk of being charged higher PPM rates.

Many people in the UK are unable to access cheaper rates for their energy, as they are locked into using PPMs. These include the unbanked population, who are automatically excluded from direct debits, and consumers in debt to their energy suppliers or who have a poor credit rating, for whom the energy companies can impose PPMs. People on fluctuating incomes often budget on a weekly basis, so bill payments every three or six months are unrealistic and inappropriate, making PPMs the only viable option. As these people are disproportionately on lower incomes, the current energy pricing model charges more to those who are least able to pay.

Ofgem's principal objective is to protect the interests of consumers. In this review of unfair pricing, Transact urges Ofgem to further consider the issues faced by vulnerable consumers, particularly those with no other suitable payment method available to them but PPMs.

[1] Ofgem Fuel Poverty Summit Brief, April 2008
[2] National Energy Action, Prepayment Meter Use by Household Type 2005

Responses to specific questions

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?*

Transact supports the aims, as set out in section 2.1, of avoiding undue regulatory risk, avoiding a disproportionate regulatory and enforcement burden and providing for the removal of superfluous licence requirements. We also recognise that it is vital for energy companies to be incentivized to compete, innovate, reduce costs and promote sustainability, to avoid possible cartelization of the energy market and to ensure that all consumers have access to affordable sustainable energy.

However, Transact believes that these aims do not sufficiently address the concerns of vulnerable consumers, as mentioned in section 2.1. Under the proposals for licence requirements outlined in Chapter 3, some vulnerable consumers are likely to experience higher costs, particularly those in rural areas or using pre-payment meters.

Ofgem's "principal objective is to protect the interests of consumers", according to the context of the report. Transact feels that Ofgem should include an explicit aim in section 2.1 of protecting vulnerable consumers from high service costs.

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

Transact do not support the approach to cost allocation as outlined in sections 2.5 and 2.6. Ofgem recommends that "costs that are directly attributable to the characteristics of a particular product should be reflected in the pricing of that product." This is likely to penalize certain groups of customers, many of whom are vulnerable and/or on the lowest incomes.

As an example, pre-payment meter customers would, under this proposal, incur certain operational costs directly attributable to the delivery method. Higher tariffs for pre-payment meter users disproportionately affect consumers on lower incomes or otherwise vulnerable consumers. 37% of people in social housing use a pre-payment meter, as opposed to 12% in the general population[3]. 36% of the

[3] Section 9.5, Ofgem Energy Supply Probe – Initial Findings Report (October 2008)

unemployed and 35% of single parents[4] use pre-payment meters, further illustrating that people suffering disadvantage are disproportionately affected by their usage.

We cannot therefore support full cost allocation on a product-by-product basis. Transact believes that administration costs should be shared between users of different payment methods.

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?*

We are pleased that Ofgem recognize the strong social responsibility that energy providers have towards their customers. There are some arguments in favour of price discrimination on social grounds, as outlined in section 2.7, such that the poorest customers pay less for their energy. However, Transact considers the extension of current Social Tariffs as a possible partial solution to issues faced by vulnerable and disadvantaged consumers and so does not necessarily advocate price discrimination on social grounds. We believe that equalizing payment charges between different payment methods under the current structure would be just as beneficial to customers and energy providers. We would be interested in any further elucidation of Ofgem's proposals around this issue.

As Transact's remit does not extend to environmental issues, we would prefer not to comment on objective justification of price discrimination based on these issues, except to note that any such provision should not penalize those who live in poor quality housing that is not energy-efficient. These people are already disproportionately on lower incomes and face high bills for heating their homes; further penalization on environmental grounds could have dramatic consequences for them.

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?*

Transact agrees with Ofgem that materiality thresholds are not necessary for licence conditions or guidance, as this may invite persistent low levels of undue price discrimination.

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?*

[4] National Energy Action statistics - http://www.nea.org.uk/prepayment-meters/

Transact cannot comment on regulatory enforcement.

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?*

Transact feels emphatically that the proposals for licence requirements should apply to all energy suppliers, not just the largest energy companies. All energy suppliers have a social obligation to their customers not to overcharge or to levy unfair price differentials. Some smaller firms are leading the way on eliminating price differentials, such as Ebico, who have equalized tariffs for all users.

Furthermore, imposing licence requirements on some firms and not others may have a negative impact on competition, by directing vulnerable and low-income customers into particular firms which they know are less likely to charge unfair price differentials due to licensing arrangements. Different licence arrangements may restrict customers' interest in switching suppliers, leading to decreased competition within the energy market.

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?*

Transact do not believe that the measures outlined in the Initial Findings Report will be sufficient to guard the most vulnerable customers against unfair price differentials. While we welcome the moves towards ending price differentials without clear cost justification, we do not see this as enough to prevent customers on low incomes or without the ability to switch payment method from paying more for their energy.

Because of this, we do not think that it is appropriate at this point for the proposed licence conditions to become inactive at a specific predetermined point. We would call for a status review of any new licence conditions after three years to assess their impact on vulnerable consumers.

Chapter 3

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

Of the four options outlined in Chapter 3 of this consultation document, Transact supports Proposal B: Prohibition of undue price discrimination, although not without some reservations.

Proposal A: Cost-reflective pricing between payment methods, does not go far enough in terms of protecting consumers, particularly the most vulnerable. By allowing full cost reflectivity, this condition will disproportionately impact upon poorer customers.

Ofgem identifies in section 3.6 situations where non-cost reflective premiums for standard credit and PPMs affect vulnerable customers disproportionately, such as when customers do not have bank accounts, have poor credit profiles or must use PPMs because of the type of housing they live in. Transact asserts that even fully cost-reflective pricing will have a disproportionate impact upon these groups, as there will still be higher premiums paid for PPM usage, due to the administrative costs of this payment method. Transact calls upon Ofgem to take further action to protect the most vulnerable consumers from pricing differentials, whether fully cost-reflective or not.

Transact welcomes the assertion in section 3.8 that suppliers would be required to ensure transparency on the amount per annum that relates to the payment type chosen by the customer, but requests more information on how exactly this would occur. We recommend that the suppliers should have to provide regular statements to all of their customers, outlining not only how much they could save by switching to a cheaper payment method, but also providing information on how to switch. This will benefit many customers, but will not address the issues of customers who are forced into using a particular payment method (usually PPMs) because of their circumstances.

Proposal B: Prohibition of undue price discrimination is Transact's preferred option of the four supplied. This condition should prevent suppliers from charging customers unfairly because of their circumstances. As section 3.17 outlines, when features of a product mean that it is not accessible by particular customer groups, the absence of cost reflectivity would be likely to be viewed as discriminatory. One particular example of this would be lower tariffs for standard credit and direct debit customers, as those who budget on a weekly basis are effectively excluded from this.

Transact also welcomes this condition as it should allow Ofgem to put an end to any 'predatory pricing' that may occur, leading to anticompetitive pricing and disadvantaging groups of consumers.

However, we would again call for more equalization of tariffs beyond that which can be justified by reflecting differences in costs. We believe that section 3.13 of this report implies that there should be tariff equalization between different forms of payment method: "*Such a condition would be designed to address situations where consumers are losing 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.*"

PPM customers, who often are forced into this payment method as a result of their personal circumstances, will still be charged more than other customers under a fully cost-reflective pricing basis. As an example, many people moving into homes with a PPM already installed find either that energy companies will not remove the PPM for a certain period or will charge for its removal, thus effectively locking in low-income consumers. Transact is currently campaigning for PPM tariffs to be lowered to the same rates as those for standard credit customers; we believe that the wording of this proposal justifies tariff equalization.

Proposal C: Relative price controls is unlikely to be as effective as Proposal B in addressing the concerns of vulnerable consumers. Again, as is outlined in section 3.25, there is much scope for consumers locked into particular payment methods to be disadvantaged; "*… we would expect the premium for PPMs over direct debit to be greater than that for standard credit over direct debit.*"

We agree with Ofgem that this relative price control may be a simple and transparent form of regulation (section 3.29); however, our concern is that this will not provide sufficient protection for vulnerable consumers. "Headroom" in price limits could be used to justify charging poorer customers more for their energy, as firms migrate towards the upper end of allowable pricing.

Furthermore, there is likely to be informational asymmetry between Ofgem and the suppliers, with the suppliers possessing more knowledge of their costs and profit margins and the relative costs of serving different types of consumer within particular tariffs. This will lead to market distortions and the controls are likely to be set at inappropriate levels, based on the regulator's necessarily incomplete picture of individual suppliers' pricing models.

Transact welcome Proposal D: Prohibition of "cross-subsidy" between gas and electricity supply, as complementary to Proposal B. This proposal addresses the specific issue of higher prices charged to customers taking only electricity under a single fuel arrangement (section 3.35). We feel that this licence condition is necessary to protect those customers who do not have access to the gas grid and so have to pay more for their fuel.

We agree with Ofgem's contention that this licence condition, by eliminating undue cross-subsidy, will help to rebalance gas and electricity prices and reduce barriers to entry for new firms, thus increasing competition and ensuring better deals for consumers.

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

Transact agrees with Ofgem's assertion in section 3.8 that suppliers should be required to issue regular statements to their customers. This would need to make clear how much extra customers are being charged for their use of PPMs or standard credit. Furthermore, Transact feels that suppliers should have to enclose information on how customers can switch to lower tariffs as part of this regular statement. This will help to alleviate problems of competition by increasing information available to consumers.

However, Transact still contends that it is not appropriate, with regard to vulnerable customers, to insist on full cost reflectivity of payment methods, as this

Question 3: (Proposal B) *How would we best apply such a condition in order to minimize concerns over regulatory uncertainty and risks to competition and innovation?*

Transact supports Proposal B and believes that the prohibition of undue discrimination will aid competition and innovation. However, the definition of 'undue' discrimination is unclear and might lead to a high degree of regulatory uncertainty. Transact argues that any definition of 'undue' price discrimination should cover differences in customers' circumstances, such as unbanked customers who may find PPMs the only option available to them.

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

Transact considers that Ofgem should take account of a range of circumstances which restrict customers to particular payment methods, as a particularly important non-price issue. As an example, many people on low or fluctuating incomes need to budget on a weekly, rather than monthly, basis, making PPMs a much more suitable method of payment than quarterly billing. Furthermore, those people who have PPMs in their homes because of the actions of previous residents can be restricted to

PPM use and so have to pay higher premiums for their energy than they would otherwise. Finally, customers already in debt to their suppliers can be trapped paying high PPM premiums until their debt is cleared, but the higher costs of energy via PPMs makes getting out of debt a longer process.

Question 5: (Proposal B) *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?*

Cross-subsidisation is an issue for consumers who are not located on the gas grid and so pay higher prices for electricity. This prohibition of undue price discrimination should include consideration of customers who pay higher prices due to lack of access to gas, and cheaper tariffs should be available where appropriate to these consumers.

Question 6: (Proposal C) *How would we best apply such a condition in order to minimize concerns over risks to competition and innovation?*

As Ofgem identifies, condition has the potential to impact on competition by stifling innovation and preventing competitive entry. However, if "headroom" was included in the price controls, as is suggested in section 3.32, it is likely that at least some suppliers will increase their tariffs to the maximum allowed under the price control, particularly for vulnerable customers who find it difficult to switch to other suppliers or payment methods. Although this headroom might aid competition overall, again it is likely to impact on the most vulnerable consumers and those on the lowest incomes disproportionately.

Question 7: (Proposal C) *Which price differentials should be covered by relative price controls?*

Transact do not support the implementation of relative price controls, believing that this proposal unfair to vulnerable customers, who will continue to pay high premiums for PPM use or who are unable to switch to cheaper suppliers. As such, we cannot recommend specific price differentials to be covered by relative price controls.

Question 8: (Proposal C) *How would we define the relevant benchmark tariffs by payment method and by geographical area?*

Transact would prefer not to comment on this issue.

Question 9: (Proposal C) *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)?*

Transact do not expect that this solution, or any of the other proposals set out in this document, will make the market fully competitive and fair for consumers within the near future. As such, we do not support the imposition of a definite sunset clause on price controls. However, if this proposal is implemented, price controls should be regularly reviewed, perhaps more frequently than every three years, as suggested in section 3.27.

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

As mentioned in the previous answer, Transact feels that price controls should be under periodic review. However, if prices change substantially, fuelled by an event such as a rise in the price of oil, the price controls should be re-opened and reviewed.

Question 11: (Proposal C) *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?*

Transact would prefer not to comment on this issue.

Question 12: (Proposal C) *Would a revenue cap be preferable to a relative price cap?*

A relative price cap would be preferable to a revenue cap, as there is a closer link between the cost of supply and the price charged to consumers than between supply costs and total revenues of energy companies. As consumers see prices, rather than revenue, a relative price cap would be more transparent than one based on revenue.

Furthermore, Transact agrees with Ofgem's assertion in section 3.34 that a revenue cap could be less effective than a price cap in protecting specific consumers, in that it allows suppliers more flexibility within each tariff. Transact considers the protection of vulnerable consumers, such as those who are trapped on high pre-payment meter tariffs, to be of the highest priority, and as such, would be extremely concerned about the imposition of a revenue cap.

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

Transact is concerned about the high margins earned on single fuel electricity customers, particularly those who cannot access cheaper dual fuel deals through lack of access to the gas grid. This issue particularly affects rural consumers, who may suffer from a number of compounded disadvantages, such as difficulty in accessing pay points for PPMs and lack of access to local banking. We view this proposal as a sensible way of tackling these high margins through prohibition of cross-subsidisation between gas and electricity customers. Transact does not have any further suggestions as to alternative means of addressing this serious issue.

Question 14: (Proposal D) *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?*

The principle of materiality should be sufficient to identify issues of cross-subsidy to be acted upon. This allows for a greater degree of flexibility, such that smaller cross-subsidies that impact particularly upon low-income households should be addressed, as well as larger cross-subsidies which impact upon the general consumer population. Transact therefore supports part 2 of the draft licence condition.

Question 15: (Proposal D) *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?*

The proposed prohibition of cross-subsidy between gas and electricity supply is intended to protect those who pay more for their energy through expensive electricity-only deals. While there are significant problems of access to the gas grid, making this a problem for many rural customers who cannot access cheaper dual fuel tariffs, there is not a corresponding lack of access to the electricity grid. Few customers, if any, are forced into accepting gas-only tariffs, as they can access electricity. Therefore, a reciprocal condition not have the same effect of protecting consumers from paying unfair price differentials based on their location, and as such, Transact believes that this is not necessary.

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.*

Transact is unable to comment on the overall potential impacts of the proposals as set out in this document.

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

Transact's remit is to represent the views of its members, who are concerned about the effects of payment methods and other charges on vulnerable consumers; those who are financially excluded, suffering from poverty or wider social exclusion and those in debt, either to energy suppliers or multiple debtors. As such, we can only comment on the potential impact on vulnerable consumers.

While these proposals, particularly Proposal B, go some way towards alleviating the poverty premium paid by low-income consumers for their energy, particularly through the use of pre-payment meters, Transact believes that none of these proposals go far enough in protecting the interests of customers, which is Ofgem's principal objective.

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

As above, Transact is unable to comment on this issue.

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?*

As above, Transact is unable to comment on this issue.

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

As above, Transact is unable to comment on this issue.

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

Transact believes that an unintended consequence of all of these proposals as they stand will be to further marginalise vulnerable consumers by allowing firms to charge them more based on their payment method. The proposals still allow for fully cost-reflective differentials in pricing based on payment method, as PPMs cost more for suppliers to provide than direct debit or standard credit payments.

Under all of these proposals, firms will still be able to charge PPM users more for their energy, while there is no obligation on them within these proposals to switch customers to cheaper tariffs or even to provide information on how to switch. While the proposals will reduce rates for many consumers, PPM users will still pay most, despite being disproportionately on low incomes, in receipt of benefits or in debt.

We believe that these proposals will lead to the creation of a class of people within the energy market who are forced to pay higher prices through being locked in to PPM use due to their circumstances. Customers who cannot switch to cheaper payment methods include those budgeting weekly and those with bad credit ratings or in debt to their suppliers.

Transact urge Ofgem to conduct further research identifying and quantifying the extra costs to suppliers of providing energy through PPMs, before considering these regulations. Transact believe that the additional costs of servicing PPMs should be borne by suppliers as part of their social responsibility to protect consumers, as they impact particularly on consumers on the lowest incomes.