Response to Ofgem consultation ‘The Standardised Element of Standing Charges under the Retail Market Review’

April 2012

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

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Setting the context

In our wider response to the Retail Market Review (RMR) proposals[1] we set out our views on the strengths and weaknesses of introducing a simplified standard tariff. It is our view that Ofgem has not provided sufficient evidence or analysis to date that would justify the introduction of the core tariff proposals. This follow-up consultation focused on the narrower issue of what should be included in the standing charge for that tariff, were the proposal to go ahead.

In general, this submission therefore concentrates on the practical implications of different standing charge components rather than any discussion of the wider merits of the simplified standard tariff proposals themselves. The only exception to this is in the specific area of questioning whether having a standing charge at all makes sense if it is extremely narrow; eg one of your options suggests that the gas standing charge could be £0.

Key issues

We detail our position in greater depth in our answers to the consultation questions that follow, but a high level summary is that:

- We support a narrow definition of the components of the standing charge that only includes fixed costs that are outside suppliers control, *but*
    - the value of having a standing charge at all appears questionable if this may be in the £0 (gas) to £13 (electricity) bracket implied by your consultation
    - there may need to be some uplift to the contents of the narrow definition so that it reflects deminimis costs to serve, in order to avoid issues around degradation of service for consumers that could otherwise only be served at a loss[2]
    - neither of the proposals for catering for regional differences is particularly simple. If simplicity is the goal of this intervention, there may be value in considering wholly flat national tariffs

A narrow definition of standing charges

We remain of the general view that any standing charge should be a narrow charge limited to covering the costs that are outside of the supplier's control eg where there is no possibility of contractual negotiations or efficiency savings.

In addition, we believe that fixed standing charges should exclude the costs of social and environmental schemes for three key reasons.

[1] **http://bit.ly/xtA0Pc**

[2] Most supplier responses to the RMR expressed concern about the financial risk that an Ofgem set standing charge would expose them to, with small suppliers expressing significant concerns that this could damage their viability. Ofgem should conduct an impact assessment on the impact of its proposals on competition in the market.

Firstly, because it would be inconsistent with polluter pays principles to apply the same level of environmental taxes on every consumer regardless of their carbon footprint.

Secondly, because the broad correlation between energy consumption and income would mean this approach would disproportionately hit the fuel poor.

Thirdly, because it would have a distortive effect on competition, given that some suppliers are exempt from some of these schemes.

These principles point towards the adoption of the narrowest definition of the standing charge that you have proposed, although we do have concerns that this could understate the deminimis cost to serve a customer – a point we will explore in greater depth later.

Why have a £0 standing charge?

Your consultation appears to envisage that a narrow standing charge could be in the region of £13 per year for electricity and £0 per year for gas (see Figure 1).

If the standing charge is likely to be zero, or nugatory, this does call in to question whether it is worth having a standing charge at all. The presence of a separately specified, but (near) zero, item on consumer bills or in advertising may be confusing to consumers and drive increased costs in the form of consumer contacts with suppliers seeking to clarify what this item is.

Fig 1: Wide or narrow standing charge?

	Illustrative annual cost for average consumer (£)	Recovered through standing charge	Recovered through unit rate
Gas transmission	6	✗	✓
Gas distribution	122	✗	✓
Electricity transmission	19	✗	✓
Electricity distribution	81	✓(£13)	✓(£68)
Energy Company Obligation*	29 (gas), 29 (elec)	✓	✗
Warm Home Discount*	7 (gas), 7 (elec)	✓	✗
Metering*[i]	23 (gas), 15 (elec)	✓	✗
Other supplier fixed costs*	25 (gas), 25 (elec)	✓	✗

'Wide' standing charge

'Narrow' standing charge

** If included in the standing charge.*

i Metering cost estimates are based on traditional meters, not smart meters.

	Electricity	Gas
'Wide' Standing Charge	≤ £89	≤ £84
'Narrow' Standing Charge	£13	£0

While, as we will explain later, we think the narrowest standing charge probably needs to be broader than £0/£13, in the event that you reach the view that this is the materiality of the standing charge we would encourage you to do further research into consumer responses to seeing a nil / nugatory standing charge in advertising and on bills. It may be the case that having no standing charge at all is less confusing that having one set (close) to zero.

Additions to reflect deminimis cost to serve?

Although we hold the general view that any standing charge should be a narrow charge limited to covering the costs that are outside of the supplier's control, eg where there is no possibility of contractual negotiations or efficiency savings, we recognise that this could cause anomalies in some circumstances.

The most obvious of these will be in circumstances of abnormally low consumption. While suppliers will have the scope to reduce their costs for, say, billing and metering, they will never be able to reduce these to zero. So if they are entirely dependent on the unit rate to cover their costs this may force them to run at a loss if the consumer uses few units. Implicitly, any losses suppliers are forced to suffer to serve low use consumers are likely to be smeared over higher use consumers. This will result in cross subsidy. Insofar as income and energy usage are broadly linked – put simply, the poor tend to use less – this may be regarded as progressive, although it does bring some risk of unintended consequences.

The most obvious of these is that it may make low use consumers extremely unattractive to suppliers, because they will be forced to serve them at a loss. This may result in a degradation in the quality of service that they receive, as suppliers attempt to cut their losses. Given the need to decarbonise, and the higher prevalence of vulnerable customers in lower consumption deciles, embedding incentives that encourage suppliers to treat high consumption customers well, and low consumption customers less so, may not be a desirable outcome.[3]

We think a way to try and tackle this may be to allow suppliers to recover a set amount of revenue to recover their metering and other fixed costs through the standing charge but to set this amount at a level that reflects the 'best in class' (ie cheapest delivery while meeting acceptable service standards to consumers). This would allow the most efficient suppliers to recover their costs for supplying low consumption households, while maintaining incentives on all suppliers to improve their efficiency in the delivery of these services in order to get closer to, or beat, the benchmark. This would not prevent low consumption sites from being loss-making, but would mean that this was no longer inevitable. This should create healthier incentives on suppliers with regards to treating that tranche of customers well.

Catering for regional differences

You present two options for catering for regional differences in cost to serve. Both of these appear quite confusing and we struggle to understand how either would be explained to consumers.

Option 1 – Ofgem set regional adjuster

Option 1 would involve each supplier setting a national unit rate to go along with an Ofgem set national standing charge. Ofgem would then set a regional adjuster which '*would then be added to suppliers advertised national unit rates to determine the total unit rate for each supplier in a given region'.* The regional adjuster would be made by reference to the cheapest region, therefore a zero adjuster would apply in that region.

But Option 1 is silent on *when* the regional adjuster would be added, and by *whom*. As we highlighted in our wider response to the RMR, the tabulation of 14 different regional rates could lead to a messy and confusing table. If suppliers are not required to do this, then naturally they may simply advertise based on their national unit rate. In 13 out of 14 regions this will not represent the price the consumer will actually pay. While this inaccuracy would not affect consumers shopping around between standard tariffs (because every supplier's standard tariff would be subject to the same uplift in that region) it would affect consumers shopping between standard and non-standard tariffs – because one would effectively be net, while the other was gross. Tools like internet price comparison may be able to get around this systemic bias – but it would seem to rather defeat the purpose of introducing 'simple' tariffs if they are sufficiently complex that you need a price comparison engine to understand them. If consumers' first awareness that they are paying a regional adjuster comes when they receive a bill this is likely to undermine levels of trust in energy suppliers still further.

Option 2 – supplier set regional unit rate

Option 2 would see Ofgem set a national standing charge, while suppliers set a regional unit rate.

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[3] We recognise that this risk will already exist where every unit sold is a profitable unit. However, it is likely to be aggravated by this proposals.

This would remove the problems of like-for-like comparison between standard tariffs and non-standard tariffs that Option 1 suffers from. It would also reduce, though not entirely remove, the problem of 'missing money' (eg that the price you see advertised is not the price you will actually pay) that Option 1 suffers from – albeit there is still some risk of this occurring in relation to any advertising campaigns taking place near regional boundaries.

Option 2 does have limitations however. In common with Option 1, national advertising of energy supply products would be complicated because of the need to show 14 different regional prices (or show just one, which is wrong in 13 of the 14 regions). Even regional advertising is potentially complicated because print and broadcast media will straddle energy region boundaries. Consumers will also need to know which region they are in. Tools like internet price comparison could help with this but, again, it is not clear to us that existing users of price comparison services are the kinds of consumers you need to be reaching if this intervention is to work. As we highlighted in our response to the wider RMR, there is limited evidence from other sectors to suggest that consumers make switching decisions purely on the basis of a best buy table. We consider that Option 2 is less imperfect than Option 1 is, although still far from perfect. We would like to see you consider a third option – flat national pricing for standard tariffs.

Option 3 – flat national pricing

If you want 'simple' tariffs to be genuinely simple, we think it is worthwhile exploring a model comprising a single, nationally uniform, standing charge and a single national unit rate that is set by the supplier – with no regional adjusters.

This would reduce all the complexity inherent in Options 1 and 2 because national advertising campaigns would not need to be full of the small print or risk of confusion that would be associated with regional pricing. It would also bring energy products in line with more easily understood products such as telephony and broadband – which do not tend to be regionally priced.

Underlying differences in the costs to serve different regions would remain, but the network price controls provide a means to ensure that these are efficiently incurred. A mechanism to ensure no competitive distortion between suppliers would also be needed. In its response to the wider RMR, EDF Energy suggested the introduction of a centralised harmonisation / neutrality mechanism that sought to make suppliers neutral to the introduction of nationally uniform pricing by unwinding any windfall gains or losses associated with having disproportionate presence in regions with higher than average, or lower than average, network charges.

Implicitly any move to nationally uniform pricing is likely to create winners and losers – for example, reducing fuel poverty in high cost to serve regions while increasing it in low cost to serve regions. Understanding the distributional impact would be a crucial first step to gauging the desirability of such an approach. It would introduce cross subsidies between regions that would dilute the cost reflectivity of supplier tariffs; a trade off would need to be made between the relative merits of cost reflectivity versus simplicity. Nor do we suggest that the design of a neutrality mechanism would be straightforward.

However, from a simplicity perspective nationally flat pricing is likely to be much more intelligible to consumers than either of the regional approaches you suggest. We think you should consider such an approach in further depth.

Answers to consultation questions

Question 1: Do stakeholders agree with our proposed approach to those costs that should be recovered through a standing charge and those costs that should be recovered through a unit rate?

We believe that fixed standing charges should exclude the costs of social and environmental schemes for three key reasons.

Firstly, because it would be inconsistent with polluter pays principles to apply the same level of environmental taxes on every consumer regardless of their carbon footprint.

Secondly, because the broad correlation between energy consumption and income would mean this approach would disproportionately hit the fuel poor.

Thirdly, because it would have a distortive effect on competition, given that some suppliers are exempt from some of these schemes.

Regarding other costs, we remain of the general view that any standing charge should be a narrow charge limited to covering the costs that are outside of the supplier's control (eg where there is no possibility of contractual negotiations or efficiency savings). However, we believe there may be a need to allow suppliers to recover a deminimis amount, set at a level that would reflect 'best in class' efficiencies, to cover the unavoidable component of flexible costs such as billing and metering. We think this is necessary to ensure that you do not create a situation where all low consumption consumers become loss leaders, creating perverse incentives on suppliers and degrading the services that those consumers receive.

Question 2: Do stakeholders have any comments on the proposed broad assessment of the possible elements of the standing charge (set out in Appendix 1)?

See question 1.

Question 3: Do stakeholders have any comments on the treatment of regional cost differences? Do they favour Option 1 or Option 2?

We consider both options 1 and 2 to be highly confusing. Neither is likely to be conducive to clear national advertising campaigns and both run the risk that consumers will not actually understand what unit price they are paying until a bill arrives. Option 1 is particularly poor because it would impede price comparison between standard and non-standard tariffs – one would exclude regional adjusters while the other would include them.

If the overarching aim of this intervention is simplicity we think there may be value in considering introducing nationally flat standard tariffs – described as Option 3 earlier in this document. An assessment of any distributional impact of Option 3 would need to be carried out before deciding on whether to progress it – although this is equally true of Options 1 and 2. Consideration would need to be given to an industry neutrality mechanism in order to ensure that uniform tariffs did not create competitive distortions based on differences in regional market share.

Question 4: Do stakeholders have any comments on the assessment of the individual elements of the possible regional adjuster (set out in Appendix 2)?

The assessment of the individual elements appears to be correct but we do not support the concept of the regional adjuster.

Question 5: Do stakeholders agree with our proposed treatment of the standing charge (based on a broad assessment) and possible regional adjuster (using a formulaic approach) in the licence conditions?

No comment.

Question 6: Do stakeholders agree with the proposed timing of any potential changes to the standing charge and possible regional adjuster?

We agree that it makes sense for the standing charge to be adjusted on a periodic basis to reflect changes in underlying network charges. While we do not agree with the regional adjuster approach, if you are to go ahead with it, it would make sense for the adjuster to change on the same dates as the standing charge.

Any mandatory revision date chosen is likely to have an influence on suppliers' wider decisions on when to alter their prices, because the incremental costs to suppliers of increasing or reducing their unit rates at such times will be much lower than if they were making a 'standalone' price rise/cut. The timing will also have an effect on the extent to which suppliers recover costs in the year that they are incurred, or whether surpluses or shortfalls are carried over from year to year. There is some risk that this approach could lead to all suppliers changing their prices on the same date. If all price movements are synchronous this may make like-for-like price comparison easier – though it may also compound consumer trust issues around collusion, 'all suppliers being the same', etc.

Given that network charging years run from 1 April, this may suggest that is the most appropriate timing for revision. Although 1 June would allow for more time for suppliers to notify their consumers, the misalignment of network charging and consumer charging years is likely to result in some risks to suppliers, which may get priced through to consumers. We recognise that suppliers receive limited notice of the changes to network charging that will take effect on 1 April but think it may be more appropriate to require the networks to give suppliers more notice than to stagger the network and B2C charging years.

Reforming standing charges

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