Making a positive difference
for energy consumers

Gas and electricity suppliers,
consumers and their representatives,
and other interested parties

Date: 20 May 2014

Dear Colleague,

Price differences between payment methods

Under Standard Licence Condition (SLC) 27.2A of the supply licence, gas and electricity suppliers cannot charge more for one payment method compared with another, unless this can be justified by cost. In February 2014, Ofgem issued a request for information to suppliers on the prices they charge domestic consumers for different payment methods. This letter sets out our findings.

Our analysis found no evidence to suggest that costs are being unjustifiably added to the bills of typical prepayment and standard credit customers. Indeed the differential paid by gas prepayment customers is typically below what would be justified in cost terms. Overall, since Ofgem took steps to address unjustified price discrimination in 2009, the difference in price for a prepayment customer compared to one paying by direct debit has fallen significantly from £140 to around £80 per year. Average price differences for standard credit customers are also around £80 per year at present compared to those paying by direct debit. Looking ahead, we would expect to see price differences fall with the roll-out of smart meters, for example because the meter can operate in both smart and prepayment mode, removing the need to install and maintain a prepayment meter.

Under SLC 27.2A suppliers can choose not to have any price difference and, where they do, they have a degree of latitude over how they allocate costs between payment methods. The majority of suppliers, including all larger suppliers, charge higher prices to customers that do not pay by direct debit.

There is significant public interest in whether the current differences - even if cost justified - are fair. This is a complex issue and any change in approach, including a more prescriptive one, would create winners and losers. While low income customers and those in vulnerable situations are more likely to pay by means other than direct debit, there are still a large number of fuel poor customers who pay by direct debit who would be adversely impacted by any reallocation.

It is for suppliers to justify their prices to consumers and in developing their policies we would expect suppliers to engage with stakeholders who have expressed an interest in these issues. To facilitate this, and recognising the wider public policy issues involved, we plan to hold a roundtable with suppliers, consumer representatives, parliamentarians and the government in the summer.

More detail on our analysis is provided in the attached appendix. If you would like to discuss any of the issues raised in this letter, please contact Adhir Ramdarshan on 0207-901-7000 or adhir.ramdarshan@ofgem.gov.uk.

Yours faithfully,

Rachel Fletcher
Senior Partner, Markets

Appendix 1 – Summary of analysis

Requirement for price differences between payment methods to reflect costs

There are three main ways in which domestic consumers can pay for electricity and gas. The majority do so by direct debit. Around 30 per cent pay by standard credit and around 15 per cent by prepayment meter.[1]

For various reasons, suppliers face different costs for the different payment methods they provide. In 2008, as part of the Energy Supply Probe, Ofgem identified consumer detriment arising from price differences between payment methods that did not have a full cost justification.[2] We were particularly concerned that consumers who do not have a choice about payment methods were being harmed. For example, those without a bank account who cannot pay by direct debit or those who are restricted to a prepayment meter because they are in debt with their supplier. In response to these concerns, we introduced SLC 27.2A in 2009. This requires that any differences in the terms and conditions offered to domestic consumers in respect of different payment methods are cost reflective. SLC 27.2A was also introduced to reflect requirements in European Union (EU) Directives.[3]

When SLC 27.2A was introduced, we published guidance setting out the principles we intended to take into account in interpreting and applying this licence condition.[4] Among other things, this guidance recognised that suppliers cannot be precisely cost reflective at all times. We also stated that we did not intend to pursue pricing of payment methods that is not cost reflective which results in lower prepayment charges. This is because we interpreted the EU Directives as intending, among other things, to protect consumers who pay by typically more expensive payment methods, including prepayment.

The majority of suppliers, including all larger suppliers, charge higher prices to customers that do not pay by direct debit. SLC 27.2A provides important protection to consumers, including those that cannot change how they pay for their gas and electricity, from unjustified price differences. However, price differences do play an important role in helping to signal to consumers that suppliers incur higher costs in providing certain payment methods. Where consumers respond by moving to cheaper payment methods, this helps to lower bills by reducing overall costs for suppliers.

To ensure that they are compliant with SLC 27.2A, we expect suppliers to have in place a methodology for ensuring that any price differences between payment methods are set in a cost-reflective manner. We expect this methodology to be robust, comprehensive and updated regularly.

Responses to information request

On 7 February 2014, we issued an information request asking suppliers to describe their approach to setting price differences between payment methods and to explain why they considered this ensured any differences were cost reflective. We also asked for their total annual costs for 2012 for the cost categories that differ by payment method. We chose 2012 because this was the latest calendar year for which annual costs were available.

We issued the information request as part of our work to monitor suppliers' compliance with SLC 27.2A. It was also relevant to our assessment of the state of competition in the energy market with the Office of Fair Trading and the Competition and Markets Authority.

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[1] *Quarterly Energy Prices*, Department of Energy and Climate Change, March 2014.
[2] *Energy Supply Probe – Initial Findings Report*, Ofgem, October 2008.
[3] Annex A(d) of Directive 2003/54/EC concerning common rules for the internal market in electricity and of Directive 2003/55/EC concerning common rules for the internal market in natural gas.
[4] *Guidelines on Cost Reflectivity between Payment Methods and the Prohibition of Undue Discrimination in Domestic Gas and Electricity Supply Contracts*, Ofgem, August 2009.

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The information request was voluntary. We received responses from 13 suppliers, including all larger suppliers, of which nine provided data on how their total annual costs for 2012 differed by payment method.

Our findings

For the suppliers that provided data, we undertook analysis on the extent to which price differences between payment methods reflect the costs incurred.[5] We found no evidence to suggest that costs are being unjustifiably added to the bills of typical prepayment and standard credit customers.

Costs differences between payment methods

The data provided in response to our information request shows that suppliers' costs vary for providing different payment methods. The costs of supplying prepayment customers are generally higher than for direct debit customers. This is in part due to the need to install a prepayment meter at the customer premises, which is more expensive to buy and maintain than a credit meter. Prepayment also relies on a bespoke payment infrastructure.[6] Moreover, issues specific to prepayment customers, such as problems in topping up the meter, mean they are more likely to call their supplier resulting in higher costs to serve.

The costs of supplying standard credit customers are also higher than for direct debit customers. The data submitted by suppliers indicates this is primarily driven by bad debt costs, including debt management costs and recovery of debts, provision for bad debts and bad debt write-offs where appropriate.

Comparing cost and price differences between payment methods in 2012

Our analysis assessed, for each supplier, the differences in their costs against the differences in their prices for gas and electricity for: prepayment and direct debit customers; and standard credit and direct debit customers. Comparing these figures gives an indication of whether price differences for each supplier reflect the costs incurred in offering different payment methods.

Our estimate of the cost differences used the data provided by suppliers in response to our information request. Our analysis did not examine in detail the cost information submitted by suppliers. To estimate the price differences, we calculated the typical annual bill for a single fuel direct debit, standard credit and prepayment electricity and gas customer based on the observed price of each supplier's standard variable tariff in 2012. Where prices changed over the year, we took an average. Our estimate used Ofgem's estimate of typical domestic consumption values in 2012. These were 16,500 kWh for gas and 3,300 kWh for electricity.[7]

Our analysis found no evidence to suggest that costs were being unjustifiably added to the bills of typical prepayment and standard credit customers in 2012. Figure 1 below shows the average of cost and price differences between payment methods in 2012 for the five larger suppliers covered. These estimates are weighted to take account of the number of customers served by each supplier. They do not include prompt pay discounts available to

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[5] Scottish Power was excluded from our analysis because, at the time it was conducted, we had not finalised an investigation into their compliance with SLC 27.2A. At the conclusion of this investigation, we found that Scottish Power was not compliant with SLC 27.2A in the period up to December 2012. We are satisfied that Scottish Power has now taken appropriate steps for the purpose of securing compliance with SLC 27.2A. Therefore, we do not plan to proceed with enforcement action for the period after December 2012.
[6] Prepayment Meter Infrastructure Provision is a system for reconciling back to the relevant energy supplier the advance payments made by prepayment customers at outlets, such as corner shops or post offices.
[7] We recognise that suppliers may use different estimates in setting prices based on their knowledge of their customer base.

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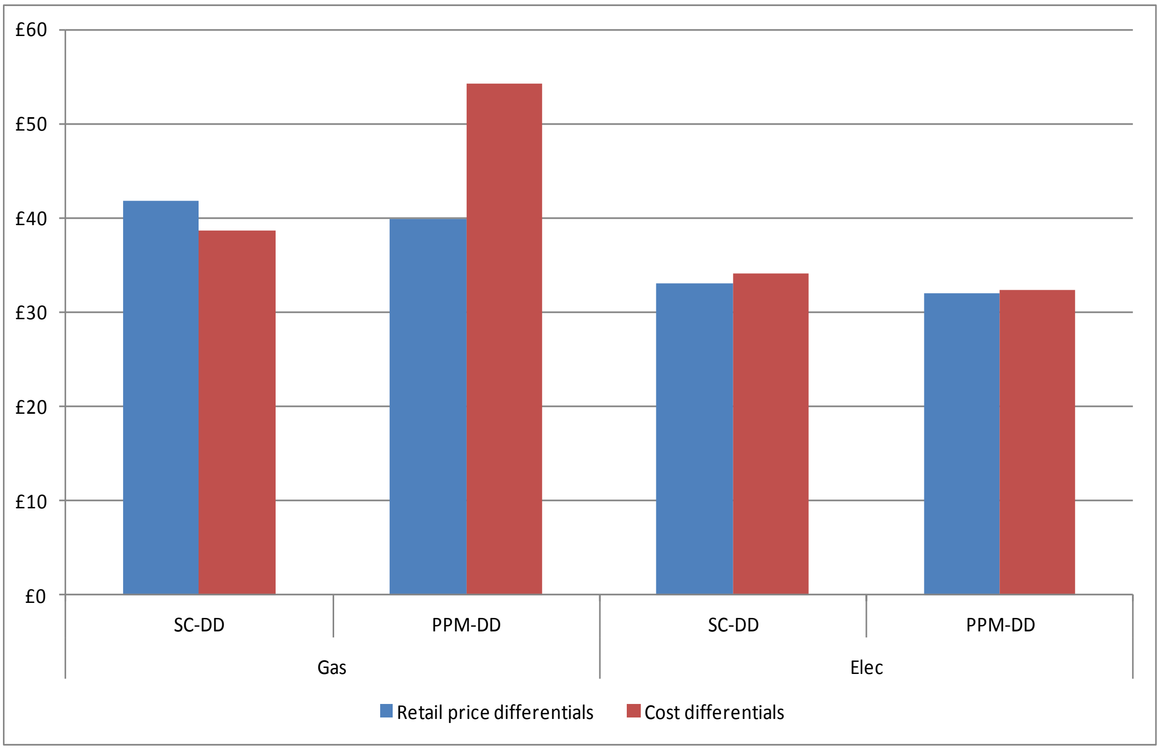
standard credit customers in 2012. Figure 1 does not show differences between individual suppliers. However, it reflects our conclusion that consumers are not being harmed by unjustified price differences between payment methods.

Figure 1 – Weighted average cost and price differences between payment methods in 2012[8]



As indicated in Figure 1, price differences between gas prepayment and direct debit for these suppliers were on average actually lower than their cost differences. Costs are higher for these customers because gas prepayment meters are significantly more expensive to install and maintain in comparison to credit and electricity prepayment meters. This suggests that some of these costs were being recovered across customers generally, helping to reduce price differences between prepayment and direct debit. As set out above, we consider that this practice is not inconsistent with the intent of the EU Directives on which SLC 27.2A is based.

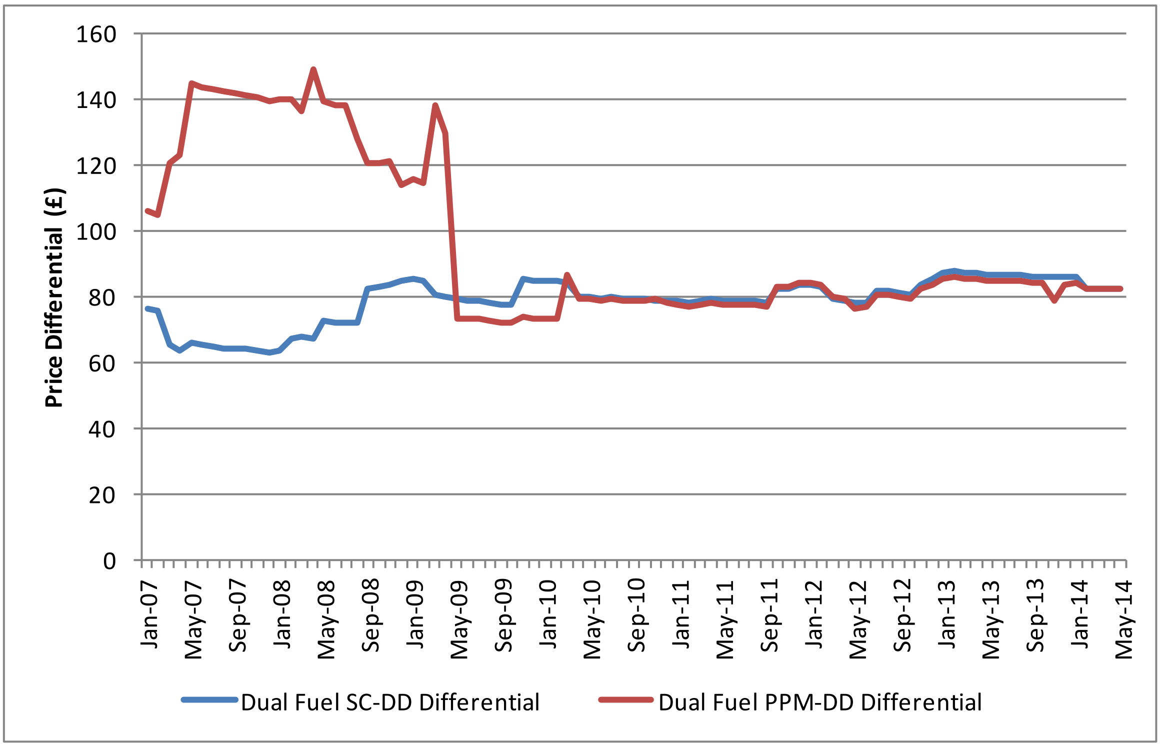
Changes in price differences over time

While our analysis focused on 2012, we also looked at how these price differences have changed over time. Figure 2 below shows, for the five larger suppliers covered, the difference in the annual dual fuel bill by payment method in 2014 prices.

Figure 2 shows that, since May 2010, differences in bills between standard credit and prepayment customers compared to those paying by direct debit have broadly remained the same at around £80 per year. This followed a significant fall in the difference between prepayment and direct debit customers in 2009 when Ofgem was taking steps to address unjustified price differences.

[8] The information on standard variable tariffs that we used to estimate the price differences shown in Figure 1 was sourced from Energylinx.

Figure 2 – Differences in the annual bill of an average customer paying by standard credit and prepayment compared to paying by direct debit[9]



Our analysis reveals that price differences between payment methods have remained broadly the same since 2012. We have no reason to believe that the relevant costs underlying these differences have changed significantly. On this basis, we have no evidence to suggest that costs are being unjustifiably added to the bills of typical prepayment and standard credit customers at present.

Other sectors

Direct comparisons between price differences in gas and electricity bills and those in other sectors, such as water and communications, are difficult. The companies in these sectors operate in a different regulatory framework, particularly in water where the end price for consumers is regulated. Moreover, the costs that companies incur in offering payment methods may be different. For example, prepayment is not available in the water sector and the equivalent in the communications sector does not require metering at the consumer's home. The proportion of customers that pay by different payment methods may also affect costs. We understand that significantly more consumers pay by direct debit in the communications sector than do for electricity and gas.

Fairness of price differences

There is significant public interest in whether the current differences - even if cost justified - are fair. This has included suggestions that these differences should be equalised or capped in some way.

Within the existing regulatory framework, suppliers have some latitude on how they allocate costs and hence how they price different payment methods. Where they charge different prices, there are a range of ways that they can do so in a cost-reflective manner

[9] The information on standard variable tariffs that we used to estimate the price differences shown in Figure 2 was sourced from Energylinx.

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in accordance with SLC 27.2A and the guidance that sits alongside it. Alternatively, within the terms of the licence condition, suppliers can choose to charge the same price regardless of payment method, thereby spreading the additional costs they incur across all their customers.

There is no single methodology for allocating costs across payment methods that is obviously superior in terms of the impact on consumers. Any approach will lead to winners and losers, including among those in vulnerable situations. We are aware that customers on low incomes and in vulnerable situations are more likely to pay by methods other than direct debit and may not have the option to change payment method if they do not have access to a bank account. However, spreading the additional costs equally across all consumers would increase bills for direct debit customers. This includes households in fuel poverty, of whom almost 50 per cent pay by direct debit.[10] .

In setting prices, we expect suppliers to treat customers fairly based on an understanding of their customer base and to justify the price differences they charge. We also expect that price differences should reflect the benefits (such as cash flow) that might arise from different payment methods as well as costs. We do not propose to introduce requirements on suppliers relating to the way in which costs are allocated across payment methods. However, to facilitate the debate on these wider public policy questions, we plan to hold a roundtable in the summer as explained below.

Pricing behaviour of smaller suppliers

Some smaller suppliers also charge different prices between payment methods. In some instances, these differences are significant – although in other cases they can be lower than for large suppliers. Based on the information we received, we found no evidence to suggest that costs are being unjustifiably added to the bills of typical small supplier prepayment and standard credit customers. We expect all suppliers to make their customers aware of the price differences between payment methods. This helps consumers make informed choices about how they pay for gas and electricity, where they are able to change payment methods.

Higher price differences for smaller suppliers may be caused by the upfront costs incurred in establishing systems and processes necessary to support a payment method being spread over a small number of customers. In this context, we note that suppliers with over 50,000 customers are required by their licence to offer a wide choice of payment methods. Some smaller suppliers have argued that this obligation means they offer payment methods they otherwise would not due to the high costs they incur per customer.[11] Over time, we would expect that the costs for smaller suppliers would fall as they improve the efficiency of their systems and processes, and their customer numbers increase.

Protecting consumers from unjustified price differences going forward

Measures introduced by Ofgem through the Retail Market Review (RMR) will help consumers who can choose how they pay to identify savings they can realise, for example from moving from prepayment or standard credit to direct debit.[12] For example, customers will receive regular prompts on the cheapest tariff available to them from their current supplier. Price differences between payment methods must also be the same across all the

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[10] Not all consumers in vulnerable situations will be fuel poor. However, this is a relevant measure given that it is those who are struggling to pay their bills who are most likely to be affected by price differences between payment methods.
[11] There are circumstances where smaller suppliers that are not subject to the requirement to offer a wide choice of payment methods will need to offer a particular payment method. For example, where a customer is having difficulty paying their bills, the supplier must offer a prepayment meter where it is safe and reasonably practicable.
[12] The Retail Market Review was an Ofgem project with the aim of making the energy market work better at serving the interests of consumers and enable individuals to get a better deal from energy suppliers.

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tariffs that a supplier offers. This will make it clearer and simpler for consumers to identify the savings they can realise from changing how they pay for energy. Other RMR measures can help consumers to engage more effectively in the market, helping them to reduce their energy bills.

In terms of the level of the underlying cost differences, competition should drive suppliers to manage their costs as efficiently as possible. However, we have previously expressed concerns that competition is not working as well as it could. As such, we are currently considering whether to make a market investigation reference to the Competition and Markets Authority to ensure that there are no further barriers to effective competition.[13]

Looking ahead, the roll-out of smart meters to all domestic consumers by the end of 2020 will help to reduce the costs that suppliers incur in offering different payment methods. For example, smart meters can significantly reduce the higher costs to meter for prepayment compared to direct debit customers. This is in part because the meter can operate in both smart and prepayment mode, removing the need to install and maintain a prepayment meter when the customer pays in this way. As a result, it will be easier to switch between the two methods. Smart metering can also reduce the likelihood of consumers falling into debt because consumers will have easier access to more accurate and timely information about their energy consumption, providing greater awareness of the costs of energy and giving greater control over expenditure. Suppliers will also be able to identify consumers at risk of debt sooner and provide mitigating measures. For these reasons we would expect to see differences by payment method fall with the roll-out of smart meters.

Next steps

Consumers are protected from unjustified price differences by SLC 27.2A. We will continue to monitor suppliers' compliance with this licence condition, building on the analysis described in this letter. Where we identify concerns that suppliers are not complying with this licence condition, we will consider whether it is appropriate to take enforcement action.

On the issue of the fairness of price differences, as noted above, this is a complex area and any approach will lead to winners and losers, including among those in vulnerable situations. It is for suppliers to justify their prices to consumers and in developing their policies we would expect them to engage with stakeholders who have expressed an interest in these issues. To facilitate this, and recognising the wider public policy issues involved, we plan to hold a roundtable with suppliers, consumer representatives, parliamentarians and the government in the summer. Details of this roundtable and a summary of the conclusions will be published on our website in due course.

[13] *Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, Ofgem, March 2014.

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