

IDEAL ECONOMICS

Response to Ofgem's statutory consultation for a vulnerable customer safeguard tariff

by

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November 2017

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1. The proposal to introduce a safeguard tariff and the documents Ofgem published are flawed in a number of important respects. These shortcomings are liable to pervert the consultation process.
2. In summary, the proposed price cap is unlikely to deliver anything like the benefits for consumers that Ofgem has claimed for it; Ofgem has not taken into account the effect on carbon emissions; and Ofgem has not considered the alternatives effectively. A paper appended to this one¹ proposes a cap on the standing charge in energy bills, which would not only provide greater protection to consumers but also stimulate competition and cut carbon emissions.
3. Particular deficiencies in the consultation documents are as follows:-

Misleading claims about benefits to consumers

4. Ofgem appears to have exaggerated the benefits of its proposed safeguard tariff in some of the documents it issued on 11 October. Its press release announcing its price cap said "one million households will save £120 a year on average". However, in fact the technical document estimated the average saving for the (0.9) million customers eligible for it at £110 p.a..
5. The consultation letter painted a similar picture to the press release: "It will save eligible dual fuel households an average of over £120 per year... [it] will provide price protection for around one million vulnerable consumers"². There was no mention there of the fact that many of the eligible households (i.e. single fuel customers) will (according to Ofgem's estimates) save only £85 per year.
6. Moreover the estimate of savings in the technical document is wildly inaccurate. It said the above figure of £110 pa (for dual fuel customers) was based on average household consumption (medium typical domestic consumption values - TDCV). However, this price cap is applicable to consumers in receipt of the Warm Home Discount rebates. This means they are either in or at risk of fuel poverty so they do not consume anything like the average consumption level. As a result their savings will be a fraction of the amount Ofgem has claimed.
7. Consumers' savings are smaller because Ofgem is setting this price cap equal to the current price cap for customers with pre-payment meters (PPMs), which Ofgem imposed in April on the recommendation of the Competition and Markets Authority (CMA) in its Energy Market Investigation³. This has a fundamental flaw: the way it is calculated means it offers the greatest bill reductions to those who consume most energy and they are typically the least in need of protection. Those who consume relatively small quantities (including most PPM customers, as well as most of those on low incomes, in fuel poverty and on standard variable tariffs - SVTs) save only small amounts.
8. The PPM cap is calculated⁴ for each level of consumption of both gas and electricity according to a straight line drawn through prices for supplying energy at zero and the

¹ *The case for a cap on the standing charge in energy bills* (October 2017) by David Osmon (hereafter referred to as 'the appended report').

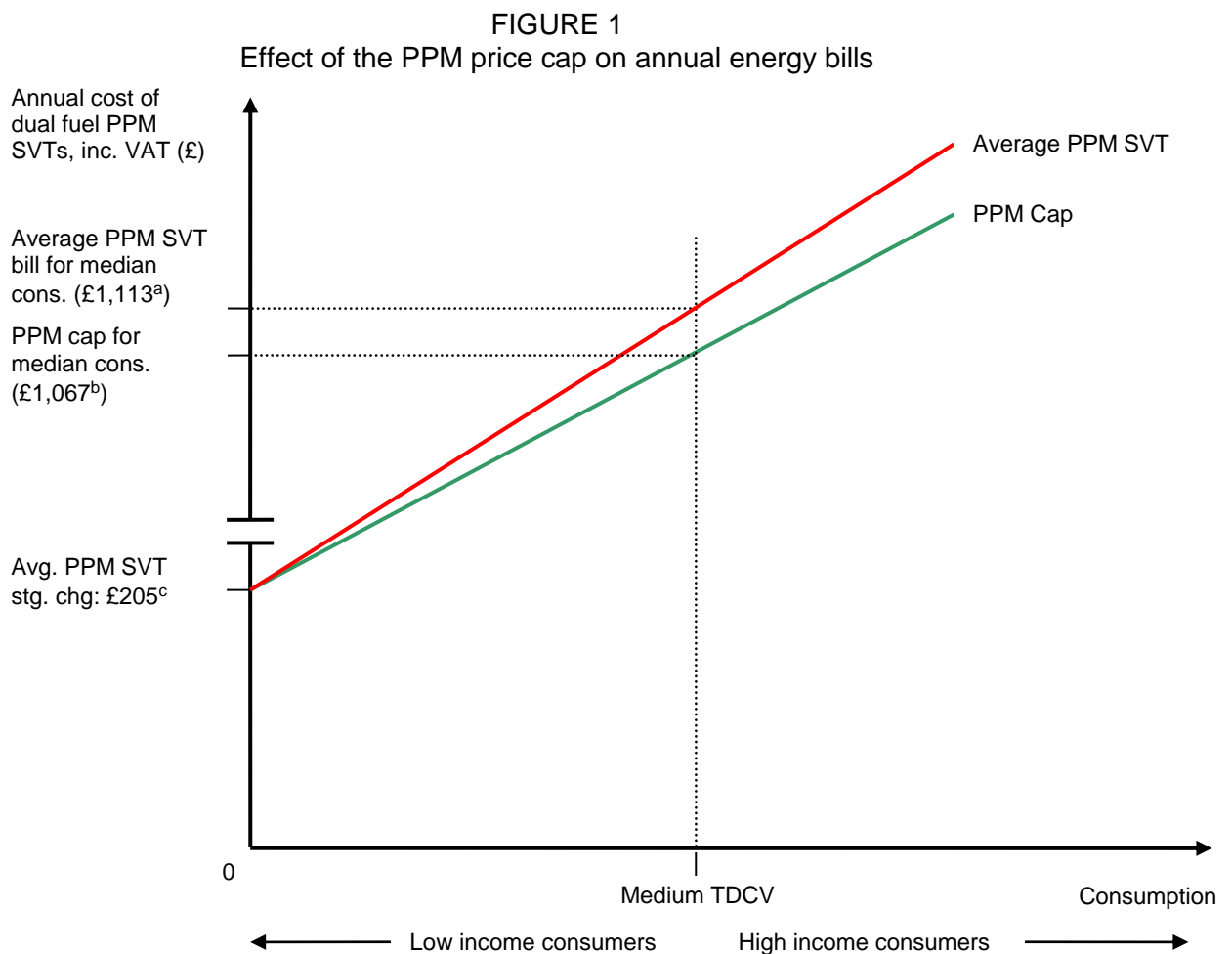
² Consultation letter p.1

³ *Energy market investigation Final report* (June 2016) Competition and Markets Authority (hereafter referred to as 'CMA final report')

⁴ CMA final report paragraphs 14.70-14.77 and 14.103-14.254.

median level of energy consumption⁵. The latter price reflects the CMA's estimate of a competitive benchmark tariff for PPM customers. However, the price at nil consumption is the average of the Big Six suppliers' PPM standing charges. This is not a competitive price: the CMA identified that the Big Six exploit their market power through their prices and that PPM customers are especially badly affected, which was the reason for the PPM price cap.⁶

- To illustrate this, the following diagram shows the effect of the PPM price cap on the annual energy bills of PPM customers with different levels of consumption (and income given the strong link between household income and energy consumption⁷). The amount PPM customers save is the vertical distance between the red 'PPM SVT' line and the green 'PPM cap' line.



^a Data for 28 Jan. and 28 Feb. 2017 (i.e. prior to imposition of PPM cap). (Source: Ofgem.)

^b For April – Sept. 2017. (Source: Ofgem.)

^c PPM cap at zero consumption for April – Sept. 2017 (i.e. gas £95.60 and electricity £99.99, excl. VAT). (Source: Ofgem.)

- This means the PPM price cap is of limited benefit to those who consume less than the median level of energy consumption. These are typically low income households, who

⁵ The median of household consumption in Great Britain is Medium Typical Domestic Consumption Values (TDCV). As of Sept. 2017 this was 3,100 kWh p.a. for electricity and 12,500 kWh p.a. for gas.

⁶ CMA final report paragraphs 154, 156-160, 162-167 and 245 of Summary.

⁷ See section 2 of the appended report.

are the most in need of help with energy bills. The PPM cap actually offers most protection to the biggest consumers⁸.

11. The CMA acknowledged this: “We note... that, when comparing the [PPM] cap to existing tariffs, it is in fact less stringent at lower levels of consumption and more stringent at higher levels of consumption”⁹.
12. For comparison, the average non-PPM SVT bill (i.e. at medium TDCV) is calculated as £1,101¹⁰ and the average non-PPM SVT standing charge is calculated as £156¹¹. Thus the PPM cap at zero consumption (£205) is actually much *higher* than the average non-PPM SVT standing charge. This appears to confirm that savings will be minimal for low energy consumers.
13. In addition, a price cap for customers with conventional meters set on the same basis as the PPM price cap should be significantly lower than the PPM cap. In setting the PPM cap, the CMA took into account that it was more costly for suppliers to serve customers with PPMs than with conventional meters, with the differential estimated at £63 p.a.. Ofgem has defended not reducing the cap by this amount on the basis that “this is proportionate given that this is a temporary measure”¹² but simply subtracting the costs to serve from the level of the PPM cap would not cause any administrative difficulty or delay.
14. The technical document confirmed that the proposed cap will have minimal impact as it has little impact on supplier revenues. “Our analysis suggests that our proposals will have a limited impact on the revenues of the largest suppliers... This risk is further mitigated by... the methodology, which includes sufficient headroom for efficient suppliers to earn an expected competitive return.”¹³

Effect on carbon emissions not taken into account

15. The consultation has not considered the effect of this price cap on carbon emissions. To the extent that such a price cap will be successful in lowering prices, it will lead to higher energy consumption and carbon emissions. However, Ofgem has entirely disregarded this effect. Its only statement is that “Carbon emissions associated with electricity generation are captured within the EU Emissions Trading Scheme (ETS) and capped. Therefore any changes in consumption should not affect emissions or the UK’s legally binding energy targets.”¹⁴.
16. This ignores the fact that Ofgem’s proposed price cap covers gas as well as electricity (for the majority who purchase gas from the same supplier as they purchase electricity) and the widely held view that the cap on emissions in the ETS is insufficiently stringent. As Ofgem will be well aware, this is why it is to be tightened from 2021 and is one of the

⁸ Thus the CMA’s analysis in its final report (paragraphs 14.295-14.310) showed that for each fuel (i.e. gas and electricity) the PPM price cap is above more of the Big Six firms’ PPM customer bills at low than at high levels of consumption.

⁹ CMA final report footnote 44, p.955.

¹⁰ Weighted average of annual SVT (direct debit) bills according to numbers of SVT customers of 10 suppliers with more than 250,000 non-PPM customers. Source: Ofgem website (SVT bills as of June 2017, no. of SVT customers as of Aug. 2017).

¹¹ Average standing charge of 10 suppliers with more than 250,000 non-PPM customers as at Sept. 2017 (see Annex 2 of the appended report).

¹² Consultation letter p.3

¹³ Paragraph 5.43

¹⁴ Technical document paragraph 5.58.

reasons the UK government has developed alternative policies to invest in low carbon generation and improve energy efficiency. (This is explained in paragraphs 2.79-2.80 and 5.238 of the CMA final report.)

17. This is a clear breach of Ofgem's statutory principal duty to protect the interests of existing and future consumers, including their interests in the reduction of greenhouse gas emissions. It also runs counter to the consumer outcome of reduced environmental damage that Ofgem seeks to deliver. (Ofgem's strategic mission is to make the most of its resources and powers to create better outcomes for consumers.)
18. Regarding the size of the effect on consumption (and hence on emissions), Ofgem cites¹⁵ the median elasticities in a review of residential electricity demand by Espey and Espey (2004). Ofgem doesn't provide the full reference for this article but these are the same figures the CMA cited¹⁶. However, choosing to cite the (lower) median elasticities, rather than the more appropriate (and higher) mean elasticities cited by the CMA is misleading and downplays the likely effect on overall consumption (and emissions).
19. Similarly, Ofgem then mentions (much lower) elasticity values for residential gas consumption in another paper (by Bernstein and Griffin). Again, no reference is provided but a literature search suggests that it refers to analysis of U.S. data (so of only limited application to this country) and that the figures Ofgem cited for gas consumption appear to be Bernstein and Griffin's estimate of elasticities of *electricity* demand. In fact the CMA found that "on average, natural gas price elasticities are greater than electricity or fuel oil elasticities"¹⁷.

Other alternatives not considered

20. Ofgem considered three alternative options¹⁸. However, one of these (mandated tariff design¹⁹) appeared not to go beyond things Ofgem has already considered (and rejected). Ofgem had previously introduced restrictions on tariff formats as part of its Retail Market Review (RMR) rules and they were removed recently on the recommendation of the CMA. The technical document also mentioned mandating a tariff without a standing charge²⁰ but Ofgem had considered fixing the standing charge in 2012 and rejected this partly because it would prevent suppliers offering tariffs with low or zero standing charges. (These previous initiatives and the CMA response to them are described in more detail in paragraphs 64 – 67 of the appended report.)
21. Ofgem stated that its reason for not mandating a tariff without a standing charge was that "any benefits for low energy consumers would be offset by the negative impact on vulnerable consumers with high energy usage needs."²¹ However, priority should be given to the effect on low income households as it is well established that they consume less energy than other households²² and, as Ofgem pointed out, low income is a characteristic of vulnerable consumers, inability to engage in the market and being on a

¹⁵ Paragraph 5.55 of the technical document.

¹⁶ CMA final report paragraph 8.9.

¹⁷ CMA final report paragraph 8.9.

¹⁸ Technical document paragraphs 3.20 - 3.26.

¹⁹ Technical Document paragraphs 3.21 - 3.22.

²⁰ Technical Document paragraph 3.22.

²¹ Technical Document paragraph 3.22.

²² See section 2 of the appended report.

more expensive SVT²³. Indeed Ofgem said that low income was “a particularly important risk factor when considering the impact of high-priced tariffs on consumers”²⁴.

22. Ofgem did not consider capping the standing charge (which would be less restrictive than fixing it), as proposed in the appended report, even though mandating tariff design “could be implemented relatively quickly”²⁵. This is a simpler, more limited alternative that would not only be more effective at protecting the consumers who are most in need of help with energy bills but would also stimulate competition and significantly reduce carbon emissions. Thus Ofgem’s proposal is not the “only option”²⁶ to achieve its objectives.

23. The main points of the appended report proposing a cap on the standing charge in energy bills are as follows:-

- A cap on the standing charge will target protection at low income households. They pay the highest price per unit of energy because they consume the least energy so the standing charge forms a large proportion of their total bill. They are also most likely to be on the most expensive tariffs (including SVTs) and in fuel poverty.
- It would be economically efficient, ensuring that prices faced by consumers represented the costs incurred by suppliers.
- Dual fuel standing charges average £156 p.a., which is approx. £100 p.a. more than the costs energy firms incur in serving customers.
- Unlike price caps generally, a cap on the standing charge will stimulate competition. It will make it easier for consumers to compare tariffs as they will only need to consider the unit rate. In addition, while suppliers will respond by trying to raise their unit rates, their ability to do this will be constrained. Those most affected by higher unit rates are those who consume most energy and they are more able to drive competition because they gain more from switching to better tariffs.
- While those in fuel poverty will be able to afford more energy following a cap on the standing charge, overall the higher unit rates will lead consumers to reduce their energy consumption. This will lower carbon emissions, improve security of supply and reduce the need for investment in additional generation capacity and network enhancements (which feeds through to energy bills).
- A standing charge cap doesn’t require legislation and will be simple to implement. It involves less intervention in the market than other measures affecting tariffs that Ofgem has introduced in recent years and in 2012 Ofgem actually considered fixing the standing charge (which is more restrictive than capping it) and set out then how it could do that.
- It will also be easier and less costly to calculate accurately and monitor compliance (for both Ofgem and suppliers) than any cap on overall bills.
- Capping the standing charge will address the scandal that suppliers can currently include in the standing charge the amounts they are charged under government

²³ Technical Document paragraphs 2.6 – 2.10, 2.14 – 2.15 and 3.7 – 3.9.

²⁴ Technical Document paragraph 2.14.

²⁵ Technical Document paragraph 3.21.

²⁶ Technical Document paragraph 4.7.

policies aimed at tackling fuel poverty and reducing carbon emissions. (These policies include the Energy Company Obligation; feed-in tariffs; the Warm Home Discount and the Renewables Obligation.) This (rather than ensuring these costs are recovered through the unit rate) is counter-productive: it makes energy less affordable for low-income households and incentivises higher energy consumption and emissions overall.

- Energy bills (in particular the standing charge) could be lower if Ofgem took action to resolve competition problems in metering markets.
 - The above benefits of lower standing charges would be enhanced if the Government withdrew VAT from the standing charge. The standing charge confers access to a supply of energy, which is a necessity. It appears to be a misconception that EU rules prevent this.
 - Capping the standing charges paid by businesses too would improve the competitive constraint on suppliers by improving price transparency and consumer engagement in the same way. It would substantially reduce the energy bills of micro-businesses.
24. Capping the standing charge more effectively satisfies Ofgem's criteria for such protection than Ofgem's current proposal²⁷.
25. Given that Ofgem's estimate of the likely savings for each (dual fuel) customer of £110 p.a. is likely to be a significant over-estimate, capping the standing charge appears to offer greater savings per customer (approx. £100 p.a.). In addition it would benefit many more households in need of protection.
26. A standing charge cap is a limited but highly effective measure that has the potential to reconcile those who believe the scale of detriment justifies intervention in the market to protect consumers with those who believe doing so would inevitably harm competition. This proposal is explained in depth in the appended report.
27. In view of the above Ofgem should consider replacing its proposed safeguard tariff with a cap on the standing charge.

²⁷ Technical document paragraph 2.19.

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Abbreviations used in this paper:-

CMA: Competition and Markets Authority. See paragraph 1.

PPM: pre-payment meter. See paragraph 1.

SME: Small and medium-sized enterprise. See paragraph 2.

SVT: Standard variable tariff. See paragraph 1.

TDCV: Typical Domestic Consumption Values. See footnote 65.

VAT: Value added tax. See paragraph 91.

Summary

1. The Competition and Markets Authority (CMA)'s Energy Market Investigation²⁸ last year identified competition problems in the retail energy market. The 'Big Six' energy suppliers²⁹ have market power over passive consumers, which they exploit in the pricing of their standard variable tariffs (SVTs)³⁰. The detriment to households was estimated at £1.4 billion p.a.. Households with pre-payment meters (PPMs) suffer particularly high levels of detriment so a price cap for them was introduced in April this year.
2. The CMA also found similar issues in the supply of energy to SMEs and estimated the detriment there at £220 million p.a. (mostly incurred by micro-businesses).
3. Greg Clark, the Secretary of State responsible for energy, has asked Ofgem, the energy regulator, to advise him what action it intends to take to safeguard customers on the poorest value tariffs and in relation to SVTs, as well as to ensure that micro-businesses are fairly treated. Ofgem has been considering introducing a price cap for vulnerable consumers.
4. Low income households pay the highest prices per unit of energy because they consume the least energy so the standing charge forms a large proportion of their total bill. (Energy bills consist of a standing charge per day and a price per unit of energy consumed: the unit rate.) They are also the most likely to be on SVTs and the poorest value tariffs generally. They are thus the most likely to be in fuel poverty so may be said to be the most in need of help with energy bills.
5. Price caps on energy bills have a number of potential drawbacks. In particular, they are liable to adversely affect competition by reducing consumer engagement and suppliers' incentives to attract customers.
6. Furthermore the current PPM price cap offers little protection to low income households, who actually include most PPM customers. The way it is structured provides the greatest benefit to those who consume most energy, who are the least in need of help.
7. This paper proposes capping just the standing charge component of all gas and electricity tariffs. This would be supplemented by a ban on suppliers offering lower unit rates for higher levels of consumption in order to prevent them effectively retaining a standing charge by charging high rates for the first units consumed.
8. This limited measure precisely targets protection at those who pay the highest price for energy but can least afford to. These are the low income households, who are disproportionately affected by the standing charge as they consume least energy and are most likely to be on the worst value tariffs and in fuel poverty.
9. There is also a strong economic case for capping the standing charge. Households have no discretion over whether they pay it and there is little competitive constraint on the amount suppliers can charge. Those (low income) households for whom it forms a significant part of their overall energy are the least likely to switch tariff or supplier

²⁸ *Energy market investigation Final report* (June 2016) Competition and Markets Authority (hereafter referred to as 'CMA final report').

²⁹ British Gas, EDF Energy, E.ON, Npower, Scottish Power and SSE.

³⁰ SVTs are suppliers' default tariffs for domestic customers (i.e. households). If a customer does not choose a specific plan, for example after a fixed tariff ends, they are moved to an SVT. Ofgem data shows that they are usually more expensive than other available deals: *Standard variable tariff comparison: 28 November 2016* (Ofgem).

because they are the least engaged consumers and their relatively small bills mean the gains from switching are less.

10. As a result the standing charges currently levied by energy firms are substantially more than the costs they incur in arranging to supply customers. Some dual fuel³¹ standing charges in SVTs cost customers more than £200 (including VAT) and the average amount paid is £156 p.a., while the appropriate, cost-reflective level would be approx £60 p.a. (see below). Thus a standing charge cap would save the poorest consumers up to £100 p.a.. The total benefit of a standing charge cap is estimated at £336 million p.a. for all those on non-PPM SVTs with below average consumption (and income). It would be higher still if the cap on PPM tariffs was replaced by a standing charge cap as this would reduce the amount most PPM customers pay.
11. Large and variable standing charges make it difficult for consumers to compare tariffs so reduce the competitive constraint on energy bills generally. The CMA described how this leads to the weak customer response to which it attributed the adverse effect on competition in retail energy markets (see paragraph 1 above).
12. Unlike price caps on the total energy bill, a cap on just the standing charge will strengthen competition. It will become much easier for consumers to compare tariffs as they will effectively only need to consider the unit rates. In addition, while suppliers will attempt to recoup the lost standing charge revenue by increasing unit rates, the higher consuming households affected by this will impose a more effective competitive constraint on prices. They are more likely to switch away from expensive tariffs as their gains from doing so are greater.
13. Lower standing charges will mean those in fuel poverty can afford more energy but overall the higher unit rates will lead consumers to reduce their energy consumption. This will lower carbon emissions. It will also avoid future increases in bills as it will improve security of supply and reduce the investment needed in additional generation capacity and network enhancements, the cost of which would have been passed on to consumers in their bills.
14. The appropriate level of a cap on dual fuel standing charges for non-PPM customers is approximately £60 p.a. (including VAT). Analysis of costs incurred by suppliers reveals that these mostly depend on the level of consumption so should be recovered through the unit rate rather than the standing charge. One case in point is the cost of government policies aimed at tackling fuel poverty and reducing carbon emissions. Moreover allowing these to be recovered (as now) through the standing charge rather than the unit rate actually makes energy less affordable for low income households while incentivising higher energy consumption and emissions overall. The main exception is the cost of providing meters in customers' homes.
15. The standing charge paid by consumers could be lower still, in which case the benefits of a cap on the standing charge would be further enhanced, if:-
 - (a) Ofgem took action to resolve any competition problems in metering markets. This could reduce the costs suppliers incur in providing meters.
 - (b) The Government withdrew VAT (currently levied on energy bills at 5%) from the standing charge. The standing charge confers the ability to access a supply of energy, which is a necessity. The belief that EU rules prevent this appears to be a misconception.

³¹ I.e. gas and electricity.

16. Similar competition problems apply to the supply of energy to SMEs and they (especially micro-businesses) face high energy bills too. Capping the standing charges businesses pay would strengthen the competitive constraint on suppliers by improving price transparency and consumer engagement in the same way. It would substantially reduce the energy bills of micro-businesses.
17. A cap on the standing charge is likely to be simple and quick to implement. Indeed Ofgem has previously set out how it would be able to fix the standing charge. It would also be easier and less costly to calculate accurately and monitor compliance (for both Ofgem and suppliers) than any cap on overall bills.
18. Ofgem apparently expressed concern that if it brought in a price cap for all SVT customers without legislation energy companies would appeal to the CMA, which rejected such a price cap. However, its alternative of a price cap for vulnerable consumers resembles what the CMA contemplated when it considered extending the PPM cap to disengaged consumers. The CMA concluded this would not be effective and proportionate (its criteria for judging a price cap).
19. The significance of standing charges appears to have been overlooked in the CMA's inquiry last year. Nonetheless this proposal efficiently achieves what the CMA had sought to do both when it considered protecting disengaged customers and when it considered simplifying tariffs to make it easier to compare them. It also meets all of the CMA's criteria for judging a price cap. It is a limited measure that is effective in protecting those who are in need of help with energy bills and on the poorest value tariffs (including small businesses) and actually strengthens competition.
20. One of the five members of the CMA inquiry panel believed that the scale of detriment justified a price cap on the total bill for all SVT customers on a temporary basis, while the rest believed that this risked undermining the competitive process. A standing charge cap has the potential to reconcile those who believe the scale of detriment justifies intervention in the market to protect consumers with those who believe doing so would inevitably harm competition.

1. Introduction

21. The CMA's Energy Market Investigation identified an adverse effect on competition in the retail energy market arising from weak customer response. Inactive customers fail to engage in the market effectively and to select suppliers offering lower prices³². This means energy suppliers have market power over them and exploit this in their pricing³³.
22. The CMA's final report in June 2016 estimated the detriment from excessive prices in SVTs to domestic customers of the Big Six at £1.4 billion a year.³⁴ The Big Six have all increased their prices further this year and Ofgem revealed recently that their profit margins were at the highest level since it began collecting figures in 2009³⁵.
23. The CMA also estimated the detriment to SME customers of the Big Six at £220 million p.a., of which £180 million related to micro-businesses.³⁶
24. The CMA found that PPM customers have suffered particularly high levels of detriment due to constraints on the number of tariffs that suppliers can offer them. The CMA's broader package of remedies will take time to implement so the CMA decided that a transitional price cap should be introduced for PPM customers. This cap does not apply to customers with smart meters that are fully interoperable³⁷ as these enable access to a wide range of tariffs.³⁸
25. The PPM cap was introduced in April 2017 and is administered by Ofgem. It will apply for each of gas and electricity until December 2020 although it may be extended in the event that the smart meter rollout is behind schedule. The CMA estimated the PPM price cap would reduce detriment to PPM consumers by about £75 each, a total of around £300 million per year³⁹.
26. The Conservative manifesto for the general election in June proposed to extend this price protection to the 17 million customers on SVTs, saving them up to £100 a year. However, following the election this commitment to legislate for a price cap was omitted from the government's plans for the next two years in the Queen's Speech. Greg Clark, the Secretary of State responsible for energy, wrote to Ofgem on 21 June 2017 to point out that it has powers that would enable it to address these problems in the market. He asked it to advise him what action it intended to take in three respects: safeguarding customers on the poorest value tariffs; considering the future of SVTs; and ensuring that micro-businesses are fairly treated.
27. In response (on 3 July) Ofgem announced plans to protect vulnerable consumers, including the option of a price cap for them. Following a summit with consumer groups in

³² CMA final report paragraph 9.562.

³³ CMA final report paragraphs 158, 160 of the Summary.

³⁴ CMA final report paragraph 10.125.

³⁵ *Latest data on Consolidated Segmental Statements, Supplier Cost Index and standard variable tariffs* (August 2017) Ofgem (https://www.ofgem.gov.uk/data-portal/all-charts?search_api_views_fulltext=pre-tax+domestic+supply+margins&=Search).

³⁶ CMA final report paragraph 283 of the Summary.

³⁷ The price cap does not apply to customers with smart meters which meet the SMETS-2 technical specification as these can communicate with any supplier. As a result, the installation of SMETS-2 meters will eliminate the technical constraints on suppliers' ability to offer PPM customers a wider range of tariffs. It will also make it possible to switch customers with a SMETS-2 smart meter remotely (at little or no cost) to a credit tariff.

³⁸ CMA final report paragraphs 11.79-11.84.

³⁹ CMA final report paragraph 14.279.

London (on 17 July), it said that it would meet with energy companies to discuss its options and would formally consult on its proposals shortly after the summer.⁴⁰

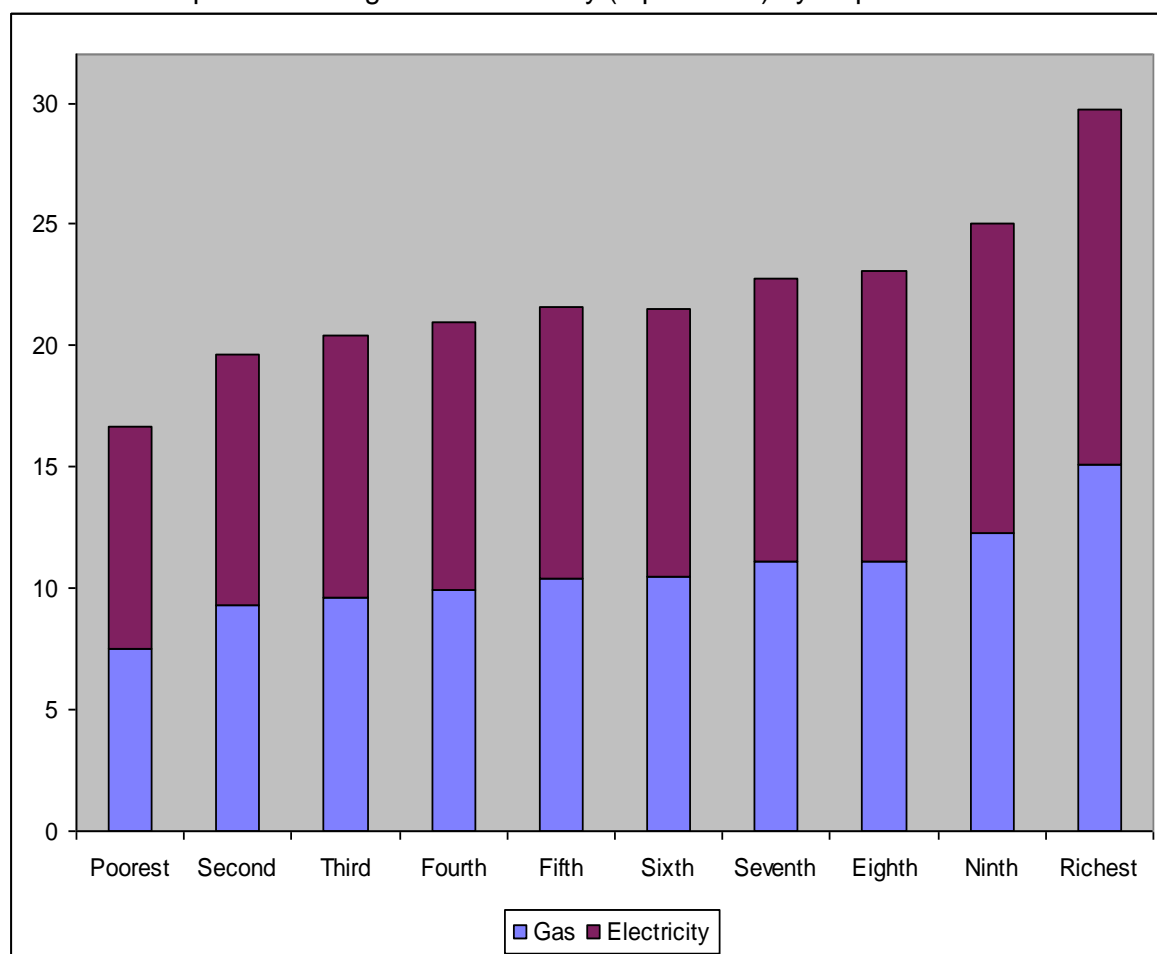
28. However, price caps on energy bills have a number of potential drawbacks. In particular, they are liable to adversely affect competition by reducing consumer engagement and suppliers' incentives to attract customers.
29. This paper makes the case for capping just one component of energy bills for both households and businesses, the standing charge. (Energy bills consist of a standing charge per day and a price per unit of energy consumed: the unit rate.) This would be supplemented by a ban on energy suppliers offering lower unit rates for higher levels of consumption in order to prevent them effectively retaining a standing charge by charging high rates for the first units consumed.
30. The main criteria for assessing this proposal are:-
 - the reduction in bills of those most in need of relief from high energy bills;
 - the effect on competition; and
 - the level of intervention, the ease of implementation and the costs of monitoring compliance.

⁴⁰ <https://www.ofgem.gov.uk/publications-and-updates/ofgem-statement-consumer-summit-vulnerable-customers>.

2. The consumers on the poorest value tariffs and most in need of help with energy bills

31. Low income households consume least energy and pay the highest price for it. Income and energy costs are key determinants of fuel poverty⁴¹ so low income households are most likely to be fuel poor and may be said to be most in need of help with energy bills.
32. The following graph demonstrates the strong link between household income and energy consumption. It can be seen that low income households consume less energy than other households.

FIGURE 1
Household expenditure on gas and electricity (£ per week) by disposable income decile



Source: *Family Spending 2016* Office for National Statistics (Table A6)

33. Income is a key determinant of fuel poverty. The median level of income for fuel poor households is £10,118 p.a. whereas the median for all households is £21,333 and for non-fuel poor households is £23,147. 78% of households that are classed as fuel poor

⁴¹ A household is considered to be fuel poor if: they have required fuel costs that are above average (the national median level); and, were they to spend that amount, they would be left with a residual income below the official poverty line. The drivers of fuel poverty are income, energy costs and the energy efficiency of dwellings.

are situated in the first or second income deciles. and virtually all are within the first three income deciles.⁴²

34. Another key determinant of fuel poverty is energy costs. Low income households pay the most per unit of energy because the fact that they consume less energy means the standing charge forms a large proportion of their total bill.

35. Low income households are also most likely to be on suppliers' SVTs and the worst value tariffs generally. That was the finding of the CMA domestic customer survey – indeed a large majority (75%) of low income consumers are on SVTs.⁴³ Ofgem's consumer survey similarly found that low income, disadvantaged and financially struggling consumers are most likely to be on SVTs⁴⁴.

36. Low income households are most likely to be on SVTs because:-

(i) Their lower consumption and relatively small bills mean the potential gains from switching are less.

Both the CMA and Ofgem have used survey evidence to estimate the amounts consumers need to save in order for switching to be deemed worthwhile⁴⁵.

(ii) They are the least engaged consumers.

The CMA domestic customer survey showed that those with household incomes below £18,000 a year are significantly less engaged. They are less likely to have ever considered switching supplier in the past; to have shopped around in the last three years; to have switched supplier in the last three years or to consider switching in the next three years.⁴⁶

Ofgem's survey of consumer engagement also detailed the link with income. Those with incomes below £16,000 a year are significantly less likely to have switched supplier; changed tariff with their existing supplier; compared tariffs and to say they have time for switching energy supplier.⁴⁷ These survey results are shown in Annex 1.

Consumers Ofgem characterised as 'unplugged' (based on measures including activity around switching and comparing suppliers or tariffs)⁴⁸ were relatively disadvantaged (e.g. 14% were from social grades AB and 43% owned their own

⁴² *Annual Fuel Poverty Statistics Report, 2017* (2015 data) (June 2017) BEIS (Department for Business, Energy and Industrial Strategy) p.4, p.26 & Table 28 of *Fuel Poverty Detailed Tables 2017*.

⁴³ CMA final report paragraphs 9.14 and 9.21-9.22. Thus the CMA domestic customer survey revealed that the proportion of consumers on SVTs is highest (75%) among those whose income is below £18k pa (CMA final report paragraph 9.14 and Appendix 9.1 paragraph 251).

⁴⁴ *Consumer engagement in the energy market since the Retail Market Review - 2016 Survey Findings (Report prepared for Ofgem)* (August 2016) Ofgem (hereafter called 'Ofgem survey report') p.77 and Table 12 of data tables (<https://www.ofgem.gov.uk/publications-and-updates/consumer-engagement-energy-market-retail-market-review-2016-survey-findings>).

⁴⁵ The CMA survey found the minimum savings needed to encourage respondents to switch supplier had a median of £120 and a mean of £204 as some customers responded with very large amounts (CMA final report Appendix 9.1 Table 12 and paragraph 120 p.38). The Ofgem survey report found that consumers feel they need to save, on average, just under £300 per year to make it worth changing their supplier or tariff (p.71).

⁴⁶ CMA final report paragraphs 9.9-9.11 and Appendix 9.1 paragraph 7 p.3 and paragraph 64 p.17. For example, 20% of those whose household incomes were below £18,000 had switched supplier in the last three years, compared with 35% of those whose household incomes were above £36,000 (CMA final report Appendix 9.1 Figure 2 and paragraph 83 p.24).

⁴⁷ Indeed the Ofgem survey also found the least engaged needed higher savings to switch (Ofgem survey report p.71).

⁴⁸ Ofgem survey report footnote 17 p.13 and Appendix.

home) and were most likely to be on an SVT (58%)⁴⁹. Those it called 'switched on' (27% SVT) were significantly more advantaged (39% AB, 76% home ownership)⁵⁰.

(iii) According to the CMA they find it more difficult to make value for money assessments of available tariff options.

The CMA listed the groups of customers that lack the capability to search and consider options fully as those with low levels of education or income; the elderly and/or those without access to the internet⁵¹.

⁴⁹ Ofgem survey report p.17.

⁵⁰ Ofgem survey report p.15

⁵¹ CMA final report paragraph 9.563(b)(i).

3. Problems with price caps

37. It is acknowledged that price caps may adversely affect competition. They can have a number of unintended adverse consequences⁵², including:-

- Reduced customer engagement as price caps reduce the gain from switching supplier⁵³. (Paragraph 36(i) above refers to research showing that the level of switching depends on the savings on offer from doing so.) Given the persistence of switching habits, the adverse effect of a price cap might continue after it was withdrawn.
- Reduced competition between suppliers to attract customers who are protected by the cap, with a risk that the price cap forms a focal point to which suppliers raise their cheaper tariffs⁵⁴.
- A perception of increased regulatory risk, which may lead investors to seek higher rates of return. This would increase costs to suppliers and ultimately the prices paid by consumers.⁵⁵

38. Presumably Ofgem will be publishing an analysis of the effects that have been observed following introduction of the PPM price cap.

39. One of the five CMA members who conducted the Energy Market Investigation considered that the scale of consumer detriment called for a price cap for all SVT customers for a short period, say two years⁵⁶. However, the majority believed this would run excessive risks of undermining the competitive process by reducing the incentives of suppliers to compete, reducing the incentives of customers to engage and increasing regulatory risk.⁵⁷

40. In addition, a number of drawbacks may not apply in respect of the PPM cap but would be more likely to apply in the case of a more general cap:-

- Suppliers might cut costs by reducing quality of service⁵⁸ and innovation⁵⁹. For example, they might delay the introduction of time-of-use tariffs⁶⁰ for those with smart meters. This wasn't a concern with the PPM price cap as fully interoperable smart meters are outside its scope but that mitigation does not apply to a more general price cap.⁶¹
- The price cap might become permanent because removal of the protection afforded by the cap would be perceived negatively. This risk is mitigated for the PPM price cap by tapering the price cap as smart meters are rolled out but this does not apply in the case of a general price cap.⁶²

⁵² The risk of these effects is likely to be higher the lower is the price cap.

⁵³ CMA final report paragraphs 14.400-14.404.

⁵⁴ CMA final report paragraphs 14.405-14.413.

⁵⁵ CMA final report paragraphs 14.420-14.422.

⁵⁶ See Statement of dissent of Professor Martin Cave in CMA final report, pp. 1415-1417.

⁵⁷ CMA final report paragraphs 250-252 of the Summary and 11.86-11.94.

⁵⁸ CMA final report paragraph 14.419.

⁵⁹ CMA final report paragraphs 14.423-14.430.

⁶⁰ Energy tariffs that charge different prices at different times of the day, week, month or year.

⁶¹ CMA final report paragraph 14.428.

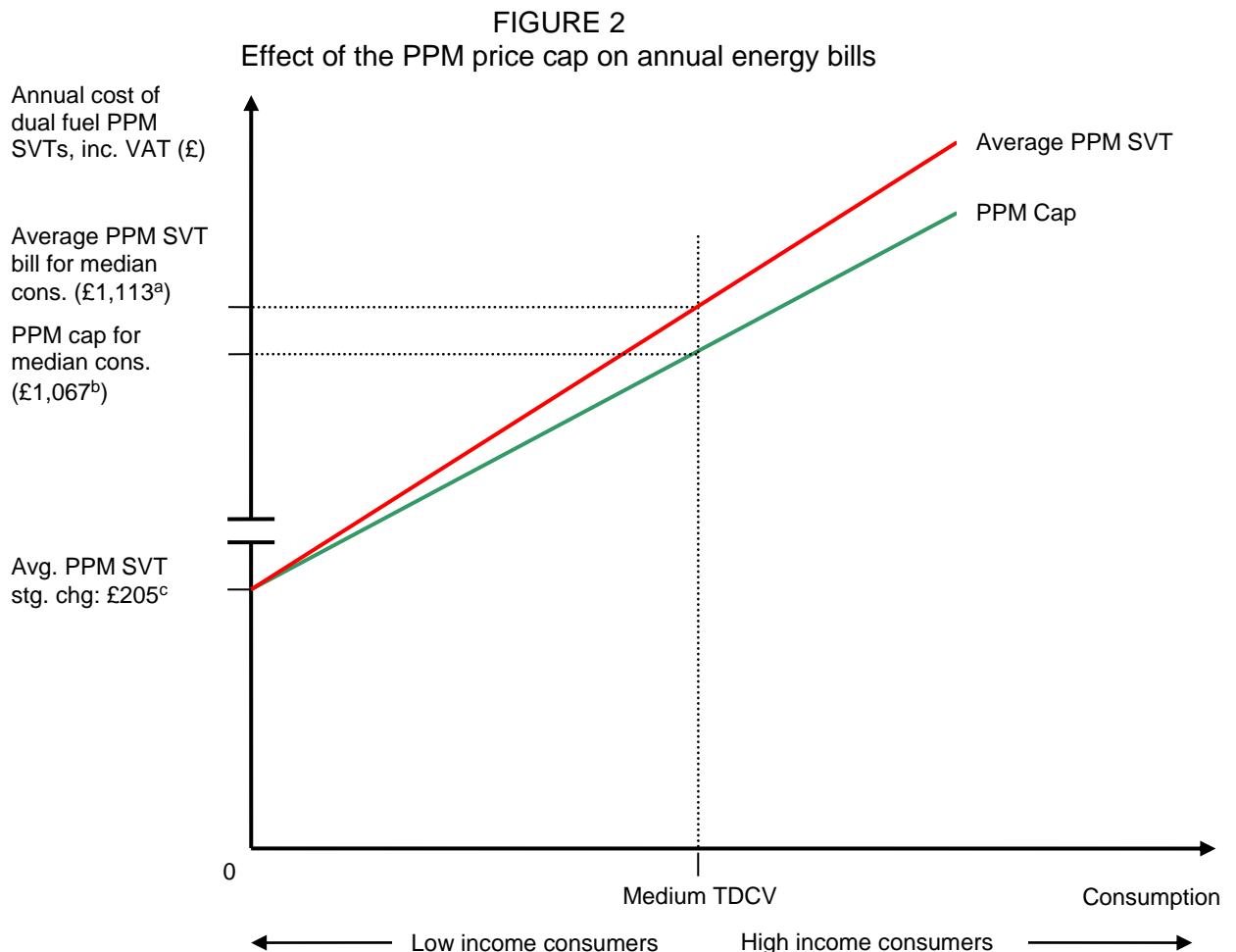
⁶² CMA final report paragraphs 14.431-14.435.

- The competitiveness of key challenger suppliers could be damaged. The proposition of 'green' suppliers (Ecotricity, Good Energy) is based on pricing near to SVT levels to fund renewable energy development. Even if they were excluded from a price cap they could very well lose market share because their tariffs might be higher than the cap.
41. The CMA considered extending the PPM cap to the types of people who are disengaged consumers: those on low incomes, with low qualifications, disabled, living in rented accommodation or above 65 years of age. It concluded that this would be ineffective and/or disproportionate, with the practical difficulties of such an approach outweighing the benefits. These demographic characteristics could not be used directly to target a cap, which would need to use benefits system proxies, and the process of identifying customers covered by the cap would have been time-consuming and inefficient.⁶³

⁶³ CMA final report paragraphs 11.95-11.97.

4. Protection afforded by the PPM price cap

42. The current PPM price cap offers little protection to low income households, who are the most in need of help with energy bills and actually include most PPM customers. The way it is structured provides the greatest benefit to those who consume most, who are the least in need of protection.
43. The PPM cap is calculated⁶⁴ for each level of consumption of both gas and electricity according to a straight line drawn through prices for supplying energy at zero and the median level of energy consumption⁶⁵. The latter price reflects the CMA's estimate of a competitive benchmark tariff for PPM customers. However, the price at nil consumption is the average of the Big Six suppliers' PPM standing charges. This is despite the CMA identifying that the Big Six exploit their market power through their prices and that PPM customers are especially badly affected, which was the reason for the PPM price cap.⁶⁶
44. The following diagram shows the effect of the PPM price cap on the annual energy bills of customers with different levels of consumption (and income). The amount they save is the vertical distance between the red 'PPM SVT' line and the green 'PPM cap' line.



^a Data for 28 Jan. and 28 Feb. 2017 (i.e. prior to imposition of PPM cap). (Source: Ofgem.)

⁶⁴ CMA final report paragraphs 14.70-14.77 and 14.103-14.254.

⁶⁵ The median of household consumption in Great Britain is Medium Typical Domestic Consumption Values (TDCV). As of Sept. 2017 this was 3,100 kWh p.a. for electricity and 12,500 kWh p.a. for gas.

⁶⁶ CMA final report paragraphs 154, 156-160, 162-167 and 245 of Summary.

^b For April – Sept. 2017. (Source: Ofgem.)

^c PPM cap at zero consumption for April – Sept. 2017 (i.e. gas £95.60 and electricity £99.99, excl. VAT). (Source: Ofgem.)

45. This means the PPM price cap is of limited benefit to those who consume less than the median level of energy consumption. These are typically low income households who are the most in need of help with energy bills. Indeed the CMA itself found that PPM customers are significantly more likely to have an income below £18,000 p.a.⁶⁷, which is less than the median income level (see paragraph 33 above), so they are likely to consume less than the median level. The PPM cap actually offers most protection to people who consume most⁶⁸ even though they are the least in need of protection.
46. The CMA acknowledged this: “We note... that, when comparing the cap to existing tariffs, it is in fact less stringent at lower levels of consumption and more stringent at higher levels of consumption”⁶⁹. However, it appeared to offer little in the way of justification for setting the zero consumption component of the price cap in this way.⁷⁰
47. In estimating the impact of the PPM cap the CMA assumed that tariffs currently below it will remain at the same level (i.e. the cap does not form a focal point to which suppliers raise their tariffs).⁷¹ As mentioned in paragraph 37 above, this may not be a valid assumption, in which case the benefits of any such cap would be lower.

⁶⁷ CMA final report paragraph 9.34.

⁶⁸ Thus the CMA's analysis in its final report (paragraphs 14.295-14.310) showed that for each fuel (i.e. gas and electricity) the PPM price cap is above more of the Big Six firms' PPM customer bills at low than at high levels of consumption.

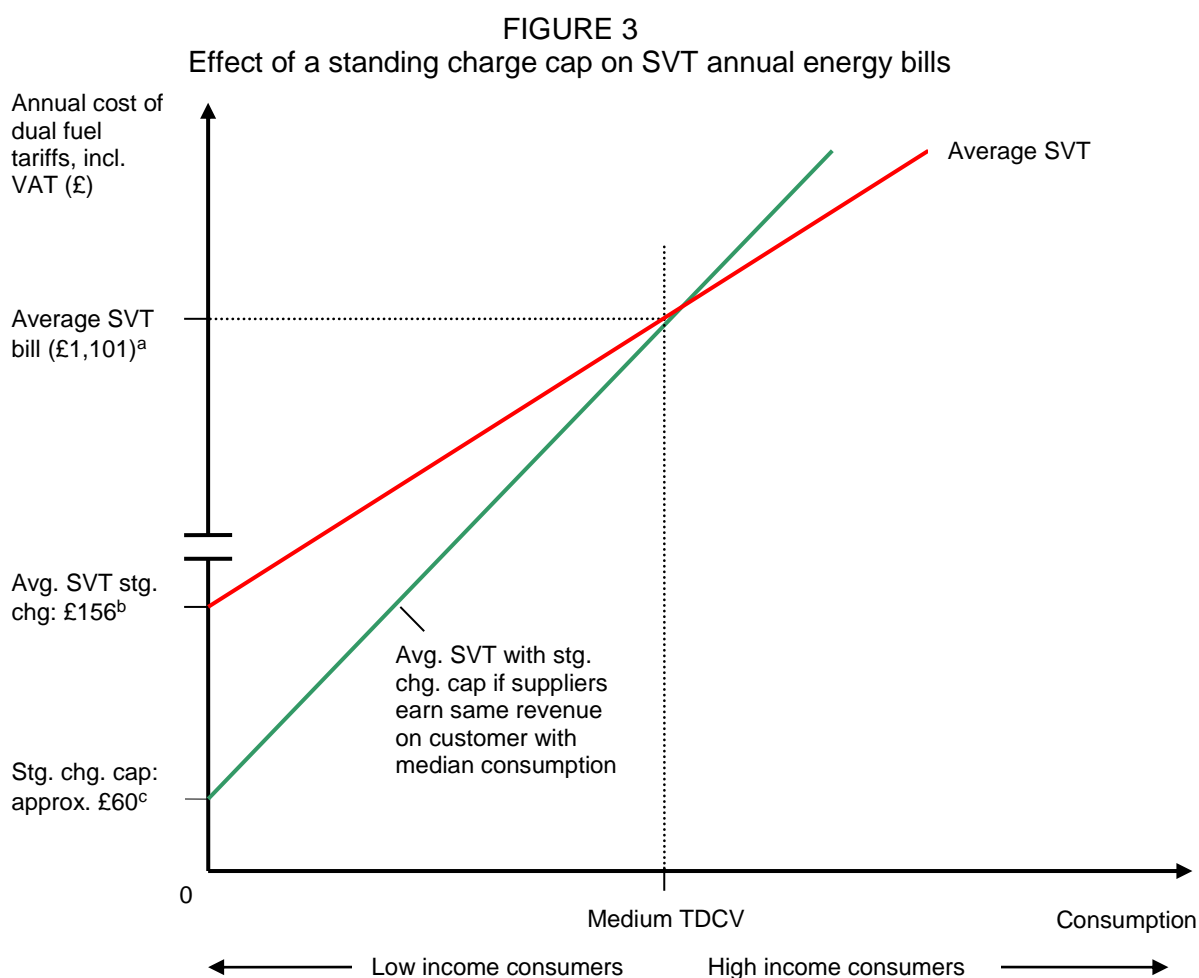
⁶⁹ CMA final report footnote 44, p.955.

⁷⁰ Its only comment appeared to be that this “provides comfort that the price cap at nil consumption is compatible with current tariff levels” (CMA final report paragraph 14.110).

⁷¹ CMA final report, paragraph 14.248(h).

5. Protection afforded by a cap on the standing charge

48. A cap on the standing charge would be effective in protecting those who pay the highest price for energy but can least afford to.
49. The burden of the standing charge falls disproportionately on those who consume the least energy because it forms a large part of their total bills and means they pay the highest price overall for each unit of energy (see paragraph 34 above). These are generally low income households, who are also most likely to be on the SVTs and the poorest value tariffs generally and to be fuel poor and most in need of help with energy bills.
50. The standing charges suppliers levy are substantially more than the costs suppliers incur in arranging to supply customers, as the next section explains (see paragraphs 57-58). The average dual fuel standing charge in non-PPM SVTs is £156 p.a. (including VAT), while the appropriate, cost-reflective level is approx £60 p.a. so a standing charge cap would save the poorest consumers on non-PPM SVTs up to £100 p.a..
51. The following diagram illustrates the effects of a standing charge cap on the annual energy bills of SVT customers with different levels of consumption (and income).



^a Weighted average of annual SVT (direct debit) bills according to numbers of SVT customers of 10 suppliers with more than 250,000 non-PPM customers. Source: Ofgem website (SVT bills as of June 2017, no. of SVT customers as of Aug. 2017).

^b Average standing charge of 10 suppliers with more than 250,000 non-PPM customers as at Sept. 2017 (see Annex 2).

^c Estimated in section 'The appropriate level of the standing charge' below.

52. The savings of below average income consumers currently on non-PPM SVTs from a standing charge cap is estimated at £336 million p.a..⁷² This corresponds to the area in Figure 3 under the red 'SVT' line and above the green 'SVT with a standing charge cap' line. This is calculated on the assumption that all consumers on SVTs are spread evenly across the consumption range.
53. In fact the consumption levels of customers generally are not spread out across the entire range but are bunched towards the median of the consumption range⁷³. However, SVT consumers are likely generally to consume less than average as low income households (who consume less) are more likely to be on SVTs (see paragraph 35 above). In this case the above figure may be an under-estimate of the benefit of a standing charge cap.
54. The CMA's estimate of the effect of the PPM cap disregarded possible secondary effects in terms of suppliers raising tariffs that had been below the cap (see paragraph 47). A standing charge cap would similarly be likely to lead suppliers to attempt to increase unit rates to compensate for their loss of revenue from standing charges. This is factored into the above estimate of savings in so far as suppliers would then earn the same revenue from customers at the median consumption level. In so far as SVT customers consume less than this suppliers would seek to increase unit rates more (in which case the savings would be less). However, suppliers' ability to increase unit rates is likely to be constrained (see section 'The effect of a standing charge cap on competition' below).
55. Note that replacing the PPM cap with a cap on the standing charge in PPM SVTs would be likely to provide greater benefit to PPM customers most in need of help with energy bills. In this case the total benefit of a standing charge cap would exceed the figure cited above as that measures the benefit to consumers on non-PPM SVTs only.

⁷² It is calculated as 14,076,746 (no. of SVT customers) / 2 * (£156 - £60) / 2. £156 is the average standing charge and £60 is the estimate of the appropriate level of a standing charge cap. The difference between these two amounts is the saving for households on zero consumption and half this is the average saving for those who consume less than medium TDCV given that the saving at medium TDCV is zero.

⁷³ However, note that there is less bunching than suggested by Figure 1, which shows consumption according to income decile, as within each income decile there is a range of consumption levels. See chart 8 of *Sub-national electricity consumption statistics and household energy distribution analysis for 2010* (2012) Department of Energy and Climate Change (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/65933/4782-subnat-electricity-cons-stats-article.pdf).

6. The economic case for capping the standing charge

56. Quite apart from the fact that it imposes a substantial burden on those most in need of help with energy bills, the standing charge is the element of energy bills for which there is the strongest economic rationale for price regulation. Households have no discretion over whether they pay it and there is little competitive constraint on the amount suppliers can levy. Moreover large and variable standing charges make it difficult for consumers to compare tariffs so weaken the competitive constraint on total energy bills generally.
57. Suppliers are able profitably to charge much more than the costs they incur in arranging to supply customers. The average dual fuel SVT standing charge is £156 (including VAT) p.a. (see Annex 2), which is about £100 more than the costs suppliers incur in enabling the supply of energy to customers (see the section 'The appropriate level of the standing charge' below). A number of firms charge much more: Ovo Energy £210 a year, British Gas £190 and Scottish Power £189. There seems little justification for such amounts given that other suppliers are able to charge much less: thus Npower charges just £116. The standing charges of each supplier are set out in Annex 2.
58. Suppliers are able to levy excessive amounts because those people who might be most averse to increases in the standing charge (those for whom it forms a significant part of their overall energy bill) are those who consume the smallest amounts. These (low income) households are the least likely to switch tariff or supplier because their relatively small bills mean the gains from switching are less and they are also the least engaged consumers (see paragraph 36 above).
59. The large and variable standing charges also make for a less effective competitive constraint on energy bills generally. They make it more difficult for consumers to compare tariffs and hence consider switching than if the standing charges were small and/or fixed, in which case they could effectively compare just unit rates.
60. The CMA detailed how this leads to the weak customer response to which it attributed the adverse effect on competition in retail energy markets, as mentioned earlier (paragraph 21). It said an energy tariff with both a fixed and variable component (meaning the standing charge and unit rate) "is likely to be more difficult for a domestic customer to understand than a tariff with just a variable component".⁷⁴ Given that the standing charge is not fixed across tariffs but varies widely (see paragraph 57 above), understanding tariffs is likely to be more difficult still.
61. These complex tariff structures contribute to inhibiting customers' value-for-money assessments of available options, particularly by those who lack the capability to search and consider options fully, notably including those on low incomes⁷⁵. The CMA said such difficulty in assessing information was a central feature giving rise to customers' problems in engaging effectively in the energy markets and identifying suppliers offering lower prices⁷⁶.

⁷⁴ CMA final report paragraph 9.165.

⁷⁵ CMA final report paragraph 9.563(b)(i).

⁷⁶ CMA final report paragraph 9.562. See also paragraphs 9.167-9.169. These cite results from the CMA's customer survey that of those (24%) who found it either fairly or very difficult to shop around, 85% found it difficult to make comparisons between suppliers and 74% found it difficult to understand the options open to them. Similarly, Ofgem's customer survey found that 36% believed it was difficult to compare tariffs.

7. The effect of a standing charge cap on competition

62. Whereas price caps on total bills are liable to affect competition adversely (see paragraph 37), capping just the standing charge will strengthen competition in two ways. Firstly, it will make it much easier for consumers to compare tariffs. Secondly, while suppliers will attempt to recoup the lost standing charge revenue by increasing unit rates, the higher consuming households affected by this will impose a more effective competitive constraint. They are more likely to switch to better tariffs as their gains from doing so are greater.
63. Considering the first of these boosts to competition, minimising the standing charge will mean that in comparing tariffs consumers will effectively need to consider just the unit rate, This is especially the case if (as seems inevitable) suppliers all set their standing charges at the cap. Moreover it will become easier to distinguish between good and bad value tariffs as the differences in unit rates between them will increase.
64. Ofgem had sought to make it easier for customers to understand and compare the tariffs on offer when it introduced its Retail Market Review reforms in 2014⁷⁷. These banned complex tariffs and limited suppliers to offering four of them⁷⁸. This was intended to improve customer engagement and thereby enhance the competitive constraint provided by customer switching
65. As part of these reforms Ofgem had notably considered fixing the standing charge⁷⁹. It decided against doing this apparently because respondents to its consultation were concerned that this would prevent suppliers reflecting their fixed costs in the standing charge and offering tariffs with low or zero standing charges⁸⁰. In fact there is no reason why setting a standing charge should mean that fixed costs couldn't be recovered (recovery of costs through the standing charge is discussed in the section 'The appropriate level of the standing charge' below) but note that in any case neither of these objections would apply with a standing charge cap.
66. The CMA recommended that Ofgem remove the ban on complex tariffs and the four tariff rule⁸¹. It similarly considered that they made it unlikely that suppliers would offer tariffs with a low or no standing charge for low volume users but, again, note that this objection doesn't apply to a standing charge cap.
67. The CMA also considered simplifying tariffs to make it easier for customers to compare tariffs. It decided against requiring suppliers to structure all tariffs as a single rate on the

⁷⁷ CMA final report paragraph 9.164.

⁷⁸ Under Ofgem's Retail Market Review reforms (see CMA final report paragraphs 9.478-9.513; paragraphs 12.356-12.452 and Appendix 9.7) tariffs were required to consist of a standing charge and either a single unit rate or time-of-use tariffs that could not vary with consumption (see CMA final report paragraph 2 of Annex A to Annex 9.7).

⁷⁹ *The Standardised Element of Standard Tariffs under the Retail Market Review* (February 2012) Ofgem p.1

⁸⁰ *The Retail Market Review – Updated domestic proposals* (October 2012) Ofgem. Paragraph 3.11.

⁸¹ It considered that they restricted innovation and competition between suppliers. It said they prevented suppliers from offering new products or tariffs that would be beneficial to certain segments of the customer population, particularly in relation to energy usage (see CMA final report paragraphs 12.380 and 12.382). The CMA appears to have objected to them partly because they curtailed the ability of suppliers to offer tariffs with no or a low standing charge for low volume users (see also CMA final report paragraph 9.509(c)).

grounds that it might restrict suppliers' competitive offerings⁸². However, again, note that capping the standing charge would be less restrictive than the CMA's proposal as it merely caps rather than eliminates the standing charge and does not limit suppliers to just one unit rate.

68. The second way in which competition will be stimulated arises as suppliers seek to increase the unit rate in order to recoup the revenue lost from standing charges. This shifts the burden of the excessive standing charges to those who consume most energy. These are higher income households who are more likely to switch to better tariffs as they have more to gain from doing so (see paragraph 36(i)). Suppliers' ability to raise unit rates will thus be subject to a more effective competitive constraint than standing charges are currently.
69. This means that suppliers will not be able to recoup all the revenue lost from standing charges. By exposing more of energy bills to competitive pressure the overall detriment from suppliers' market power over inactive consumers will be significantly reduced. The restriction on suppliers offering lower unit rates to those who consume more will ensure that all consumers benefit from larger consumers' ability to constrain suppliers' prices.

⁸² The CMA considered requiring suppliers to structure all tariffs as a single unit rate in pence per kWh. It is assumed here that this meant no standing charge: the CMA said elsewhere that the existing tariff structure – with a fixed and variable element – was more difficult to understand than a tariff with just a variable component (CMA final report paragraph 9.165). The CMA decided against this because it considered that limiting tariff structures had the potential to stifle innovation and restrict competition and would limit suppliers' ability to respond to the smart meter roll-out by offering time-of-use tariffs (CMA final report, paragraph 12.381).

8. The effect on energy demand, carbon emissions and future bills

70. Lower standing charges will mean those in fuel poverty can afford more energy but overall the higher unit rates will lead consumers to reduce the amount of energy they consume. This will lower their carbon emissions. It will also improve security of supply and reduce the need for investment in additional generation capacity and network enhancements. The cost of this investment would have been passed on to consumers (see paragraph 77(i) below) so this will avoid these increases in their bills.
71. It is important to dispel a frequent misconception that, as a necessity, consumption of energy is unaffected by its price. It is strictly necessary to consume only a certain amount of it and as more of it is consumed the utility conferred by each additional unit diminishes so the amount consumed will depend on the price.
72. The CMA pointed out that the price elasticity of demand for energy is relatively low overall, which means that consumption reduces only slightly in response to an increase in bills⁸³. It cited a study which found that in the short run a 1% rise in domestic electricity prices reduces demand by around 0.35% (i.e. an elasticity of 0.35). However, elasticity is significantly greater in the long run (0.85) as consumers are able to respond to increased prices by installing energy efficiency measures.⁸⁴ Demand may be even more responsive to an increase in the unit rate as it is this that determines how much consumers save by foregoing consumption.

⁸³ CMA final report paragraph 8.6.

⁸⁴ CMA final report paragraph 8.9.

9. The appropriate level of the standing charge

73. The appropriate level of a cap on the standing charge depends on which elements of the costs incurred by suppliers should be recovered through it. This essentially depends on whether they are incremental costs of serving customers or, rather, related to the amount of energy consumed, in which case they should be recouped through the unit rate instead.
74. In 2012 Ofgem considered which cost elements might be included in a fixed standing charge as part of its reforms aimed at simplifying tariffs (see paragraph 65 above)⁸⁵. It assessed costs incurred by suppliers according to whether they varied with energy consumption and consulted on whether to adopt a narrow or wide definition of a standardised standing charge.
75. Those costs that might be included under the widest definition of the standing charge⁸⁶ were estimated as shown in the following table⁸⁷:-

TABLE 1
Ofgem's estimate of costs to be included in the standing charge

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

* Not included under a narrow definition of the standing charge

^m Metering costs estimates were based on traditional meters, not smart meters

^d The Distribution Use of System (DUoS) fixed charge

Source: *The Standardised Element of Standard Tariffs under the Retail Market Review* (February 2012) Ofgem (Table 2.1 p.11).

76. Ofgem said that under a 'narrow' definition the standing charge would include only network costs⁸⁸. However, it did not conclude on whether to adopt a narrow or wide definition as it decided against fixing the standing charge (see paragraph 65 above).
77. Considering the possible elements of a fixed standing charge:-

- (i) Network (transmission and distribution) costs

Ofgem determined that the bulk of the charges incurred by suppliers for use of the transmission and distribution networks should be recovered through the unit rate as

⁸⁵ *The Standardised Element of Standard Tariffs under the Retail Market Review* (February 2012) Ofgem (hereafter referred to as 'Standardised Element document') (<https://www.ofgem.gov.uk/publications-and-updates/standardised-element-standard-tariffs-under-retail-market-review>).

⁸⁶ Standardised Element document paragraph 2.10 p.10.

⁸⁷ Standardised Element document table 2.1, p.11.

⁸⁸ Standardised Element document Appendix 1 paragraph 1.2.

they varied with the amount of energy consumed. Just a small element of electricity distribution costs were to be included in the standing charge⁸⁹.

The CMA went further. In setting the PPM price cap for nil consumption at the average standing charge of the Big Six energy firms' PPM tariffs it broke the standing charge down into its components. It stated that "the value of the price cap at nil consumption does not include, nor need to include, network costs since these are volume driven"⁹⁰. It said that the network charging statements of the network companies defined 'use of system' charges to be nil at nil consumption⁹¹.

Thus it has been acknowledged that almost all (if not all) network costs should be recovered through the standing charge.

- (ii) Costs of government policies: the Energy Company Obligation (ECO), Feed-in tariffs (FITs), the Warm Home Discount (WHD) and the Renewables Obligation (RO).

These are all aimed at tackling fuel poverty and/or reducing carbon emissions. How suppliers are charged for each of these policies is described in Annex 3, along with an assessment of how these costs should be recovered.

The costs that suppliers incur under three of the four (ECO, FITs and RO) depend on the amount of energy supplied rather than the number of customers served. However, it is in any case counter-productive for the costs of measures aimed at reducing fuel poverty or emissions to be included in the standing charge rather than the unit rate. This itself makes energy less affordable for low income households while incentivising higher consumption and emissions overall.

Thus it is clearly inappropriate for these policy costs to be recovered through the standing charge.

- (iii) Metering costs

The costs incurred in providing meters clearly relate to serving customers so are appropriately recovered through the standing charge. The cost suppliers incur for providing domestic gas meters is regulated by a price cap, which is set at £15.93 pa for 2017-18⁹². Electricity meters appear to be cheaper to provide: they are less sophisticated than gas meters, which involve a hazardous substance, and the CMA allowed less for electricity meters when it set the PPM price cap⁹³.

Suppliers also need to pay for the smart meter rollout. The cost of this has been estimated at £1.50 per customer per year⁹⁴.

Metering costs are considered further in the next section of this paper.

- (iv) Other fixed costs

⁸⁹ Standardised Element document Appendix 1 paragraphs 1.7-1.11.

⁹⁰ CMA final report footnote 59 p.962.

⁹¹ CMA final report paragraph 14.144.

⁹² *Metering charges from 1 April 2017* National Grid p.6.

(<http://www2.nationalgrid.com/UK/Services/Metering/Publications/Metering-Charges/>).

⁹³ CMA final report paragraph 14.122.

⁹⁴ CMA final report paragraph 14.238.

Ofgem calculated these simply by subtracting the above costs from the typical standing charge levied by suppliers⁹⁵. Given the lack of constraint on the amounts suppliers levy as standing charges (see paragraph 58 above), this estimate is not meaningful and is liable to be a significant over-estimate.

Ofgem has said separately that suppliers' other operating costs include the costs associated with billing, bad debt and costs associated with depreciation and amortisation⁹⁶. It is not possible in this short paper to quantify all such factors and assess what proportion of them might be attributable to the standing charge. However, billing costs undoubtedly would be, while bad debt might be mainly attributable to charges for energy consumed, especially following a standing charge cap, as charges for energy supplied account for the bulk of energy bills. Meter reading costs form another category of costs that are clearly attributable to the standing charge. However, the rollout of smart meters will reduce this and the costs of serving customers generally⁹⁷.

Ofgem said suppliers earn a margin on their sales of energy too⁹⁸. It does not seem appropriate for suppliers to earn a margin on the standing charge given that this merely enables a customer to receive supply of energy and does not itself confer benefit to consumers.

78. Thus metering costs appear to be the main category of costs that do not vary with the level of consumption so are justifiably recouped through the standing charge. Other elements may be (possibly) a small element of electricity distribution costs; meter reading costs; billing costs; and some fraction of other overheads / other fixed costs.
79. Of the costs in Table 1 above, the only ones that are rightfully included in the standing charge are:-
- a. (possibly) electricity distribution costs (£13)
 - b. some proportion of metering costs (£38, although note that this may be an over-estimate given the amounts cited in paragraph 77(iii) above) and
 - c. some fraction of other fixed costs (£50).
80. This suggests that the appropriate level of the dual fuel standing charge for non-PPM customers is of the order of £50-60 (say £60 including VAT), which is much less than the standing charges currently levied by suppliers.
81. That the average SVT standing charges currently levied are excessive can also be judged by inspection of the components of the PPM cap at zero consumption. As calculated by Ofgem for winter 2017-18 according to the methodology set by the CMA, these are:-

⁹⁵ Standardised Element document Appendix 1 paragraph 1.47.

⁹⁶ *Retail Energy Markets in 2016* Ofgem p.31.

⁹⁷ CMA final report paragraph 14.119 and paragraph 3 of Appendix 9.8.

⁹⁸ *Retail Energy Markets in 2016* Ofgem p.31.

TABLE 2
Components of the PPM cap at zero consumption

£ (excl. VAT)	Electricity	Gas
Network	0.0	0.0
Policy	37.2	8.7
Other	29.8	44.8
PPM uplift	24.7	40.2
Headroom	3.9	3.3
Total	95.5	96.9

Source: Ofgem⁹⁹

82. Subtracting the PPM uplift gives a dual fuel total of £127.50 (or £133.88 including VAT), which is significantly less than the current average level of (non-PPM) standing charges of £156 including VAT (see paragraph 57 and Annex 2). Subtracting headroom (included by the CMA in order to allow suppliers to price below the cap) and policy costs (which we have shown should be recovered through the unit rate) leaves just ‘other costs’, which total £78.33 (including VAT). This may be an over-estimate given Ofgem’s previous estimate of these, as set out in paragraph 78 b. and c. above.

⁹⁹ <https://www.ofgem.gov.uk/publications-and-updates/prepayment-price-cap-1-october-2017-31-march-2018>

10. Metering costs

83. It might be possible for a standing charge cap to be set lower still, in which case the benefits of a cap would be further enhanced, if Ofgem took action to resolve any competition problems in metering markets. This could reduce the costs suppliers incur in providing meters.
84. A report published by Ofgem last year¹⁰⁰ expressed concern that competition in the provision of gas metering products and services at non-domestic premises was not as effective as it should be¹⁰¹.
85. In particular, gas suppliers incur significant costs when they switch meter provider. Incoming providers appointed by suppliers are not generally able to adopt meter assets in situ so must replace them¹⁰². These switching costs weaken competitive constraints on metering providers and form a barrier to entry¹⁰³. The limited competition, costs incurred in replacing meters and raised financing costs for meter provision (as shorter asset life means riskier investment) result in higher meter rental charges to suppliers. These are likely to feed through to end customers in their energy bills.¹⁰⁴
86. The rental charges on gas meters provided at domestic premises are regulated, although the report included evidence which might indicate that meter providers' margins on domestic-size meters are actually higher than for other meters.¹⁰⁵
87. The same issues affecting suppliers' metering costs may apply in relation to electricity meters and to smart meters once they are installed.
88. Dermot Nolan (Ofgem's Chief Executive) gave a commitment to the Public Accounts Committee in June 2014 (in relation to smart meters) that there should be a requirement (as opposed to just a commercial incentive) for suppliers to use the same physical metering equipment when a customer changes supplier¹⁰⁶. Note that this concerns the transfer of metering equipment between providers rather than whether smart meters are interoperable, which merely refers to whether different companies would be *able* to operate meters (if given permission by the meter owners).
89. Ofgem said in the report that it intended to take a number of actions to address its concerns¹⁰⁷ such as exploring the scope for encouraging meter providers to sell or rent meters in situ to incoming providers¹⁰⁸. It said that in due course it would review progress

¹⁰⁰ *Review of the non-domestic gas metering market* (March 2016) Ofgem (hereafter referred to as 'Market review report').

(https://www.ofgem.gov.uk/system/files/docs/2016/03/market_review_report_final.pdf).

¹⁰¹ Market review report p.4.

¹⁰² Market review report p.4.

¹⁰³ Market review report chapter summary p.18.

¹⁰⁴ Market review report p.30.

¹⁰⁵ It said analysis of one meter provider's costs and prices (which appeared to be representative of the industry) suggested that additional mark-ups that were unrelated to costs were being added to what were already comfortable rates of return net of inflation. (Market review report p.30.) These mark-ups were 20% for domestic-size meters and 15% for other meters (market review report footnote 43 p.30).

¹⁰⁶ Stephen Lovegrove, Permanent Secretary at the Department for Energy and Climate Change (now BEIS, the Department for Business, Energy and Industrial Strategy), gave a similar commitment. (<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/smart-meters-followup/oral/10401.html> Qs.68-73, 76).

¹⁰⁷ Market review report p.32.

¹⁰⁸ Market review report p.33.

and the effect of its actions on the state of competition in the market. If progress was not evident it would consider whether it might be appropriate to take other actions, including consulting on a market investigation reference to the CMA¹⁰⁹.

90. However, it is not known what Ofgem has done with regard to these various commitments.

¹⁰⁹ Market review report p.37.

11. VAT on the standing charge

91. The benefits of a cap on the standing charge would also be further enhanced if the Government withdrew value added tax (VAT), currently levied at 5% on all elements of energy bills, from the standing charge. This would be on the basis that the standing charge confers the ability to access a supply of energy, which is a necessity¹¹⁰. There is a belief that EU rules prevent this but that does not appear to be the case.
92. EU directives constrain the application of reduced rates of VAT. They permit no more than two different reduced rates (each of no less than 5 per cent) that can apply to a restricted set of goods and services¹¹¹. However, there are exceptions whereby EU members are allowed to charge 'special rates' of VAT – reduced rates for additional goods and services and reduced rates under 5 per cent (including zero rates). They are allowed to apply a reduced rate to the supply of natural gas, electricity and district heating.¹¹²
93. Moreover items not subject to VAT prior to the introduction of the EU Single Market in 1992 may continue to be zero-rated where the exemptions have "been adopted for clearly defined social reasons and for the benefit of the final consumer".¹¹³ It is thought that this means the standing charge could be zero-rated as energy bills (including the standing charge) were zero-rated prior to 1992.

¹¹⁰ That energy is an 'essential of life' was an argument propounded by, for example, the Mirrlees Review of the tax system (a collaborative research venture led by the Institute for Fiscal Studies) in favour of goods such as domestic fuel facing lower rates of tax. Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J. (2011), *Tax By Design*, Oxford University Press pp. 156, 159.

¹¹¹ Article 98 of the EU VAT Directive (*Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax*) (<http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32006L0112>). The categories of goods or services to which the reduced rates may apply are listed in Annex III of the Directive.

¹¹² Article 102 of the EU VAT Directive.

¹¹³ Article 110 of the EU VAT Directive.

12. Application to businesses

94. The CMA also identified features of the markets for the retail supply of gas and electricity to SMEs that give rise to an adverse effect on competition through an overarching feature of weak customer response from micro-businesses. Aspects of this included limited customer engagement; a general lack of price transparency and various default tariffs that customers can be automatically moved on to if they have not actively engaged with their energy supplier or have not agreed a contract. Detriment was estimated (conservatively) at approx. £220 million pa, of which approx. £180 million pa related to micro-business customers.
95. As with domestic energy bills, capping the standing charge on non-domestic energy bills has the potential to strengthen the competitive constraint on suppliers by improving customer engagement and price transparency. It would in any case substantially reduce the energy bills of smaller businesses that consume least energy.¹¹⁴

¹¹⁴ CMA final report paragraphs 275-299 of Summary.

13. Ease of implementation and monitoring costs

96. A cap on the standing charge is likely to be simple and quick to implement. Indeed Ofgem has previously set out how it would be able to fix the standing charge. It would also be easier and less costly to calculate accurately and monitor compliance (for both Ofgem and suppliers) than any cap on overall bills.
97. Ofgem previously proposed implementing a fixed standing charge (referred to in paragraph 65 above) by incorporating a schedule of standing charges into licences, with an automatic adjuster for subsequent years. It considered that it would be possible to estimate the level of future costs with a reasonable degree of accuracy but would monitor actual costs incurred by suppliers and might propose a change to the licence if observed costs differed significantly from those anticipated.¹¹⁵ The same process could be deployed to implement a cap on standing charges.
98. It will be much more feasible to estimate accurately just the few cost categories that do belong in a standing charge than the appropriate level of a cap on overall bills. For example, the CMA's PPM cap involved the current average PPM standing charge and calculation of a competitive benchmark tariff. Each of these had various underlying elements. For example, the PPM standing charge was broken down into policy costs, 'other costs' including margin, PPM uplift and headroom¹¹⁶. It will also be less costly for both Ofgem and suppliers to monitor compliance.

¹¹⁵ Standardised Element document paragraphs 2.26-2.29.

¹¹⁶ CMA final report paragraphs 14.109, 14.226.

14. Conclusion

99. Ofgem apparently expressed concern that if it brought in a price cap for all SVT customers without legislation energy companies would be able to appeal to the CMA, which rejected such a price cap in its Energy Market Investigation (see paragraph 39).¹¹⁷ However, its alternative of a price cap for vulnerable consumers resembles what the CMA contemplated when it considered extending the PPM cap to the types of people who are disengaged consumers (see paragraph 41). The CMA concluded this would not be effective and proportionate (its criteria for judging a price cap¹¹⁸). As such it appears unlikely that a price cap for vulnerable consumers would be acceptable to the CMA.
100. The significance of standing charges appears to have been overlooked in the CMA's investigation. The only reference in the CMA's report to suppliers' ability to levy excessive standing charges and the distributional impact of this appears to be a comment from energy supplier SSE. It said that suppliers could respond to a form of PPM price cap previously mooted by the CMA by increasing standing charges. It said this "would be particularly disadvantageous to lower users, a group which includes some of the most vulnerable consumers"¹¹⁹.
101. Nonetheless a cap on the standing charge would efficiently achieve what the CMA had sought to both when it considered extending the PPM cap to the types of people who are disengaged consumers (see paragraph 41) and when it considered simplifying tariffs to make it easier for customers to compare tariffs (see paragraph 67).
102. Moreover it meets all of the CMA's criteria for the effectiveness and proportionality of a price cap. It is also uniquely capable of fulfilling the Secretary of State's request to Ofgem to safeguard customers on the poorest value tariffs; consider the future of SVTs; and ensure that micro-businesses are fairly treated. It has the advantages over caps on the overall bill that:-
- It provides far more protection to those most in need of help with their bills (those in fuel poverty and on SVTs and the poorest value tariffs generally).
 - It substantially reduces the energy bills of micro-businesses.
 - Rather than weakening competition it actually strengthens it.
 - It reduces carbon emissions and the need for investment in generating capacity and networks.
 - Involving minimal intervention in the market, it is less onerous to implement and can be introduced quickly.
103. One of the five members of the CMA inquiry panel believed that the scale of detriment justified a price cap on the total bill for all SVT customers on a temporary basis, while the rest believed that this risked undermining the competitive process (see paragraph 39). A standing charge cap has the potential to reconcile those who believe the scale of detriment justifies intervention in the market to protect consumers with those who believe doing so would inevitably harm competition.

¹¹⁷ *Energy regulator accused of being 'scared to do its job'* by Nathalie Thomas, Financial Times, 30 August 2017.

¹¹⁸ CMA final report paragraph 14.37 and also 14.349-14.355 and 14.381-14.397.

¹¹⁹ CMA final report paragraph 14.76.

Annex 1: How consumer engagement varies according to income

TABLE 3
Ofgem survey results for how measures of consumer engagement differ according to income

%	Annual income	
	Below £16k	£16k or more
Switched supplier in last 12 months ^a		
Gas	11	17
Electricity	11	17
Ever switched supplier (not last 12 months) ^b		
Gas	33	47
Electricity	39	52
Changed tariff with existing supplier in last 12 months ^c		
Gas	8	15
Electricity	9	18
Compared tariff with own supplier in last 12 months ^d		
Gas	14	28
Electricity	12	27
Compared tariff with other suppliers in last 12 months ^e		
Gas	14	29
Electricity	14	29
Strongly agree or tend to agree with the statement about energy suppliers "Switching is a hassle that I've not got time for" ^f		
	52	44

Source: Consumer Engagement Survey 2016 (Ofgem)

^a Q.18, 19 and Tables 23, 24 of survey data tables

^b Q.20 and Table 25 of survey data tables

^c Q.35, 36 and Tables 46, 52 of survey data tables

^d Q.43, 44 and Tables 50, 56 of survey data tables

^e Q.41, 42 and Tables 48, 54 of survey data tables

^f Q121 and Table 162 of survey data tables

Annex 2: The average non-PPM SVT standing charge

The average standing charge is calculated according to the standing charges in the non-PPM SVTs of the 10 suppliers with more than 250,000 non-PPM customers in September 2017. These are weighted by the number of customers on each of these suppliers' SVTs (source: Ofgem).

TABLE 4
Large suppliers' non-PPM SVT standing charges and calculation of the average

Supplier	Name of SVT (direct debit)	Daily stg. charge (p) ^a		Total p.a. (£) ^b	No. of non-PPM SVT customers ^c
		Gas	Elec.		
British Gas	Standard - Paper and Paperless	26.0	26.0	189.87	4,847,737
E.ON	E.ON Energy Plan (fixed dir. debit)	21.9	16.4	119.89	2,248,613
EDF Energy	Standard (Variable)	26.3	18.9	164.80	1,557,526
Npower	Standard - Paper and Paperless	15.8	15.8	115.51	1,246,569
Scottish Power	Standard	27.4	27.4	189.45	1,034,426
SSE	Standard (paper billing)	16.5	16.5	120.09	2,497,297
OVO Energy	Simpler Energy Paper & Paperless	28.8	28.8	210.02	148,294
Utility Warehouse	Gold and Double Gold	21.6	22.4	160.65	248,859
Co-operative Energy	Green Pioneer Paper & Paperless	20.0	20.0	146.00	92,296
First Utility	First Variable - Paperless	27.5	5.0	118.63	155,129
		Total			14,076,746
		Average		155.54	

^a Including VAT

^b Adjusted for dual fuel discounts (i.e. offered by suppliers to customers who take both gas and electricity from it).

^c As of April 2017. Source: Ofgem website (in September 2017).

Annex 3: How suppliers are charged for the costs of government social and environmental policies and assessment of how these costs should be recovered

Each of these policies is assessed below according to whether suppliers are charged according to the number of customers they serve or the amount of energy they supply. This affects whether suppliers should recover these costs from customers through the standing charge or the unit rate, respectively.

Note, however, that it is in any case counter-productive for the costs of a measure aimed at tackling fuel poverty or reducing energy use to be recovered through the standing charge rather than the unit rate. This itself makes energy less affordable for low income households while incentivising higher consumption overall. This applies to all the policy costs below.

Smaller suppliers are exempt from the costs of three of the four policies below (ECO, FITs and WHD). There is no justification for smaller suppliers' standing charges to reflect these costs given their exemption from them. Ofgem offered the justification for small suppliers' standing charges including these costs that it would enable the smaller suppliers to recover their higher than average fixed costs.¹²⁰ However, it is not appropriate to require low consumption / low income households to shoulder the burden of rectifying that problem.

The assessment feeds into the section on 'The appropriate level of the standing charge' (paragraph 77(ii) above).

The policies in question are:-

The Energy Company Obligation (ECO)¹²¹

This aims to reduce carbon emissions and tackle fuel poverty. It requires large energy suppliers (more than 250,000 domestic customers) to install energy efficiency measures such as insulation. Each supplier's obligation is determined according to how much gas and electricity it supplies to its customers¹²².

Thus suppliers' ECO costs clearly vary not with the number of customers they serve (except at the point at which this reaches 250,000) but with the amount of energy supplied. Note that Ofgem had said previously that if ECO obligations were to be allocated on the basis of consumption rather than the number of customers it would not expect it to fall within the scope of the standing charge¹²³.

Feed-in tariffs (FITs)¹²⁴

These encourage small-scale, low carbon generation. Large suppliers (more than 250,000 domestic customers) are required to make payments to individuals and organisations for both generating and exporting low carbon electricity. The costs of the FIT scheme are spread across all electricity suppliers according to each supplier's share of the electricity

¹²⁰ Standardised Element document paragraph 1.36 of Appendix 1.

¹²¹ CMA final report paragraphs 3, 6-20 of Appendix 8.1.

¹²² CMA final report paragraphs 11-14 of Appendix 8.1.

¹²³ Standardised Element document footnote 16 of Appendix 1.

¹²⁴ CMA final report paragraphs 3, 21-23, 26-28 of Appendix 8.1.

market in terms of the amount of electricity supplied (taking into account FIT payments they have already made)¹²⁵. Thus these costs should be recovered through the unit rate.

The Warm Home Discount (WHD)¹²⁶

This requires large suppliers (more than 250,000 domestic customers) to provide support, primarily through bill rebates, to customers who are in or at risk of fuel poverty.¹²⁷ Each supplier's costs are liable to vary with the number of its customers so Ofgem considered there would be merit in this cost being recovered through the standing charge.¹²⁸ However, as noted earlier, it is counter-productive for a measure aimed at assisting fuel poor consumers to be recouped through the standing charge given that this adversely affects low income households disproportionately.

Renewables Obligation (RO)

Ofgem included this (rather than the WHD) among the main environmental and social obligations affecting suppliers¹²⁹. It requires suppliers to source a specified proportion of their electricity from eligible renewable sources or pay a penalty. However, this is clearly a cost of the energy they supply so should be recovered through the unit rate.

¹²⁵ *Feed-in Tariff Annual Report 2015-16* (Dec. 2016) Ofgem p.5 and *Feed-in Tariff: Guidance for Licensed Electricity Suppliers (Version 8.1)* (May 2016) Ofgem chapter 9.

¹²⁶ CMA final report paragraphs 3, 24-27, 29 of Appendix 8.1 of and Standardised Element document paragraphs 1.31-1.36.

¹²⁷ Those on the Guarantee Credit element of Pension Credit receive automatic rebates. (In winter 2017-18 these are for £140 off electricity bills.) Energy companies can set their own rules about which other vulnerable groups can apply for a rebate, typically those on means-tested benefits with young children or a disabled member. (CMA final report paragraph 2.108).

¹²⁸ Standardised Element document paragraphs 1.34-1.35.

¹²⁹ *Retail Energy Markets in 2016* Ofgem p.32.