

# Providing financial protection to more vulnerable consumers

## Consultation

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### Overview:

The retail energy market is not working for consumers who remain on their supplier's default tariff deal. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be. We are particularly concerned with the impact this has on vulnerable consumers, who are often less able to engage, and suffer a greater impact from high prices.

We are implementing measures to improve competition in the retail energy market, which should bring benefits to most consumers. But it will take time for these benefits to reach disengaged vulnerable consumers, some of whom may never be able to fully participate in the market.

We have already provided protection to some vulnerable consumers this winter, by applying the existing prepayment safeguard tariff level to Warm Home Discount (WHD) recipients from February 2018. However, we have been clear that this does not cover all the consumers that we want to protect. Therefore, in this consultation, we propose ways to refine the design of the WHD safeguard tariff and extend it to a broader group of vulnerable consumers. We believe an additional 2 million consumers could be protected for winter 2018-19.

Government has announced that it will be introducing legislation to put in place a temporary price cap on all standard variable tariffs and fixed-term default deals. If the price cap is in place before winter 2018-19 it will protect vulnerable consumers and we will not implement our vulnerable safeguard tariff.

Please send us your responses to this consultation by **31 January 2018**.

## Context

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The Competition and Markets Authority's (CMA) energy market investigation concluded that suppliers have a position of unilateral market power in relation to consumers who do not engage regularly in the market. It said that this was having an adverse effect on competition, and proposed a number of remedies to address the substantial consumer detriment it had identified. We have already implemented some of these remedies, and are currently developing and testing the rest.

In July we responded to the Secretary of State for Business, Energy and Industrial Strategy, saying that we planned to go beyond the CMA remedies, in order to help the more disadvantaged households in society.

In October, the government published a draft bill implementing a price cap for domestic customers on Standard Variable Tariffs (SVTs) and default tariffs. We continue to work with the government to implement its proposals as quickly as possible.

We have recently published our decision to extend the prepayment safeguard tariff to an additional 1 million consumers who receive a Warm Home Discount (WHD) rebate. This protection will be in place from 2 February 2018.

## Associated documents

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[Decision to extend the prepayment meter \(PPM\) safeguard tariff to those consumers in receipt of Warm Home Discount](#) (December 2017)

[Draft Forward Work Programme 2018-19](#) (November 2017)

[Progress on Implementation of CMA Remedies](#) (November 2017)

[Vulnerable consumers in the retail energy market 2017](#) (October 2017)

[Statutory consultation for a vulnerable customer safeguard tariff](#) (October 2017)

[Final Decision – Standards of Conduct for suppliers in the retail energy market](#) (August 2017)

[Ofgem Reply to letter from Secretary of State](#) (July 2017)

[Ofgem Regulatory Stances](#) (December 2016)

[Consumer Vulnerability Strategy](#) (July 2013)

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## Executive Summary

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On 7 December 2017, we published our decision to introduce safeguard tariff protections for around 1 million disengaged vulnerable consumers who receive the Warm Home Discount (WHD). These protections come into effect on 2 February 2018, and will see a typical dual fuel household save around £120 a year. Our decision to protect these consumers was driven by our desire to act as soon as possible. This meant we had to rely on the WHD information suppliers already held. We have been clear that this initial measure does not cover all the consumers we want to protect, and we are now exploring how we could protect around 2 million more vulnerable consumers.

### **The two-tier energy market problem and the government's price cap**

We are determined to bring an end to the current "two-tier" retail energy market which allows suppliers to charge high prices to consumers who do not engage by either switching their tariff or supplier. We are implementing measures to improve engagement and make competition run more smoothly in the retail energy market. However, it will take time for these benefits to reach all consumers, particularly vulnerable consumers who face different and, in some cases, greater barriers to engagement.

Government has announced that it will be introducing legislation to implement a temporary cap on standard variable tariffs and default deals. We will work to design the methodology for this government cap in parallel with it progressing through parliament. We expect any safeguard tariff for vulnerable consumers to fall away once the government's wider price cap is in place.

At this stage, and while the draft bill receives pre-legislative scrutiny, the timing of the introduction of the government's price cap is uncertain. We want to ensure that more vulnerable consumers receive price protection next winter, regardless of the timing of the government's cap. For this reason, we are consulting now on our proposals for further protection for vulnerable consumers. We will take the timing of the government's price cap into account when making our final decision.

### **Addressing the vulnerable consumer challenge**

Vulnerability occurs where a consumer's personal circumstances and characteristics combine with aspects of the market, to create situations where they are:

- significantly less able than a typical consumer to protect or represent their interests in the energy market; and/or
- significantly more likely than a typical consumer to suffer detriment, or that detriment is likely to be more substantial.

A consumer can be vulnerable due to a combination of reasons affecting their ability to engage with, access and afford energy (for example physical disability and financial stress). Our Consumer Engagement Survey research shows that a wide range of vulnerable consumers find it difficult to engage in the market. Research also shows consumers with vulnerable characteristics or circumstances are less likely to have switched tariff or suppliers in the last three years, and are more likely to be on high-priced standard variable tariffs. Many vulnerable households are fuel poor, and

typically spend significantly more of their income on energy than other households. The situation is particularly bad in winter, when some cannot afford to properly heat their homes.

The WHD safeguard tariff in place from February 2018, and our proposed tariff for winter 2018-19, will protect the consumers who are most affected, and most likely to be harmed, by higher prices. We want to address the detriment vulnerable consumers who can have difficulty engaging in the market experience – by being on expensive default deals – as quickly as possible.

### **Our approach**

This consultation sets out our current thinking on a new measure that will replace the initial WHD safeguard tariff coming into effect in February 2018, and protect a total of around 3 million vulnerable non-prepayment consumers in time for winter 2018-19. In combination with the existing prepayment meter safeguard tariff, we estimate that around 7 million consumers, who will be some of the most disadvantaged people in society, will receive safeguard tariff protection.

Our preferred approach is to provide price protection to consumers who qualify for certain government benefits. We will work closely with government to consider how best to use low-income and disability benefits data to target price protection at the households who need it the most. This approach would require a new data-matching exercise between the Department for Work and Pensions (DWP) and suppliers who already participate in the WHD scheme, enabled by changes to the Digital Economy Act. We recognise that there could be challenges to implement this in the time available, so in this document we also consider an alternative that relies on suppliers identifying eligible customers using information they hold which can indicate vulnerability (such as being on the Priority Services Register or being in debt). We also propose this alternative approach for smaller suppliers where it is not practical to have data-matching in place for next winter.

We have considered what methodologies for setting the safeguard tariff level could be developed for implementation next winter. We are seeking views on whether changes to the existing prepayment meter safeguard tariff methodology or a new “basket of market tariffs” methodology would be most appropriate.

### **Our next steps**

We seek responses to this consultation by **Wednesday 31 January 2018**. We may also issue a request for information to suppliers in January to assist us with developing the methodology.

We will be flexible during the consultation period, and explore other ways for stakeholders to feed in views outside of a formal consultation response. For example, smaller organisations can offer their views by email or over the phone. We will also hold workshops during the consultation period to explore our questions and proposals in greater detail. We will send out invitations shortly. Subject to the review of responses, we plan to issue a four-week statutory consultation on these proposals in spring 2018. As we approach spring, the timetable of the government’s proposed price cap should become clearer. If the government’s price cap is not going to be in place before winter 2018-19 we propose to implement our new safeguard tariff in late autumn 2018.

# 1. Why we need to act

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## Chapter Summary

In this chapter we set out our reasons for why we consider a greater number of disengaged vulnerable consumers require safeguard tariff protection, and our objectives for this protection.

## The two-tier market problem

- 1.1. The retail energy market is not working for all consumers. The market is split into two tiers, whereby consumers who change tariff or supplier benefit from competition and get good deals, while consumers who do not shop around pay considerably more. The Competition and Markets Authority's (CMA) energy market investigation found that average prices for standard variable tariffs (SVTs) by the six largest suppliers are above what would be expected to prevail in a well-functioning competitive market.<sup>1</sup> Our own data shows that around 62% of consumers<sup>2</sup> are on a SVT, and the price difference between the SVTs from the six largest suppliers and the cheapest tariff in the market recently reached nearly £308.<sup>3</sup>
- 1.2. To address the two-tier market problem, we are progressing a number of measures that aim to improve consumer engagement and get consumers moving off default deals.<sup>4</sup> This sits alongside our work to ensure faster switching and bring about the benefits of a smarter market.<sup>5</sup> Although the situation is improving,<sup>6</sup> we realise it will take time for reforms to make it easier for many consumers to participate in the market and benefit from competition. This is why, when responding to the Secretary of State in July, we made it clear that we intended to go further than the CMA recommended to help the most disadvantaged in society.<sup>7</sup>
- 1.3. In accordance with our statutory duties,<sup>8</sup> we have extended the existing prepayment meter (PPM) safeguard tariff<sup>9</sup> protection to around 1 million consumers receiving the Warm Home Discount (WHD). This will come into effect in February 2018. However, we have been clear that we want to protect

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<sup>1</sup> CMA (2016) [Energy Market Investigation – Final Report](#), p. 38.

<sup>2</sup> Based on data of domestic customer accounts with the largest ten suppliers as of September 2017.

<sup>3</sup> As of November 2017. See: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

<sup>4</sup> "Default deal" refers to either a SVT, or a fixed-term default contract.

<sup>5</sup> Ofgem (2017) [Financial protections for vulnerable consumers – technical document](#), paragraph 2.4.

<sup>6</sup> For example, based on analysis of data from electricity distribution network operators and Xoserve, in the year ending October 2017, the number of domestic consumers switching supplier increased by 20% in electricity and 25% in gas. See: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

<sup>7</sup> Ofgem (2017) [Ofgem reply to letter from Secretary of State](#).

<sup>8</sup> Ofgem's principal objective is to protect the interests of existing and future energy consumers, wherever appropriate by promoting effective competition. Ofgem also has particular duties to have regard to the interests of certain groups who are vulnerable and to consider protecting the interests of consumers via means other than the promotion of competition.

<sup>9</sup> The safeguard tariff limits how much a supplier can charge a customer per unit of energy.

more disadvantaged households. This is why we are consulting on protecting at least 2 million more vulnerable consumers in time for winter 2018-19.

## Impact of the two-tier market on vulnerable consumers

### Vulnerable consumers are less likely to engage in the market...

- 1.4. Vulnerable consumers are particularly exposed to detriment from being on poor value deals. The CMA's research showed that many types of consumers with vulnerable characteristics and/or circumstances are more likely to be disengaged than the typical consumer. Consumers with a low income, living in rented social housing, aged 65 or over, and living with a disability are more likely to have not changed supplier in over three years.<sup>10</sup> The CMA's research also shows that consumers who live in rented social housing (83%), have low incomes (75%), have no qualifications (73%), or have a disability (74%) are more likely than a typical customer (68%) to be on a SVT deal.<sup>11</sup>
- 1.5. These findings are also mirrored in our 2017 Consumer Engagement Survey. This survey sought to identify why consumers with particular vulnerability characteristics or circumstances did not engage in the market. It found that consumers who had a low income, were social housing renters, aged 65 or over or were living with a disability, were more likely to lack confidence in engaging in the market, or to be wary of the potential risks.<sup>12</sup>

### ... and are more likely to suffer detriment

- 1.6. Being on a poor value deal can make it more difficult for vulnerable consumers to pay their bills and makes it more likely that they will fall into debt.<sup>13</sup> This can lead to emotional stress and exacerbate underlying mental health problems.<sup>14</sup> The effect high prices have on a vulnerable consumer's energy usage can also lead to substantial detriment. Consumers who under-heat their homes as a result of high prices are at a higher risk of suffering issues with their mental and physical health, as well as experiencing impairment to their social well-being.<sup>15</sup> Energy affordability challenges can be particularly acute for consumers

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<sup>10</sup> CMA (2016) [Energy market investigation – final report, appendix 9.1](#), paragraph 83.

<sup>11</sup> CMA (2016) [Energy market investigation – final report](#), paragraph 9.14.

<sup>12</sup> We discuss the findings of the Consumer Engagement Survey in: Ofgem (2017) [Financial protections for vulnerable consumers – technical document](#), paragraphs 2.8 – 2.10.

<sup>13</sup> The impact of high energy prices is greater on poorer consumers, and the situation has got worse. In 2015, the poorest 10 per cent of households spent an average of 9.7% of their income on energy, compared to 5.8% of their income in 2005. Over the same period, the proportion of income that the richest 10% of households spend on energy was much lower, and changed less – from 2.1% in 2005 to 2.8% in 2015 (Ofgem calculations based on [Office for National Statistics data](#)).

<sup>14</sup> See: Gibbons and Singler (2008) [Cold comfort: a review of coping strategies employed by households in fuel poverty](#), p. 42, and Holkar (2017) [Seeing through the fog – how mental health problems affect financial capability](#).

<sup>15</sup> Centre for Sustainable Energy (2015) [Energy tariff options for consumers in vulnerable situations](#), p95.

who rely on electric heating to keep their homes warm.<sup>16</sup> Paying high energy prices also increases the number of people falling into fuel poverty.<sup>17,18</sup>

## The need to act

- 1.7. As shown above, vulnerable consumers are more likely to be disengaged and at risk of paying significantly more than they need to. This can lead to substantial consumer detriment. We are also wary that disengagement can be more embedded for vulnerable consumers and because of this, our ongoing reforms to improve the functioning of the market may take longer to benefit them.<sup>19</sup> For these reasons, we consider providing safeguard tariff protection is proportionate.<sup>20</sup>
- 1.8. The safeguard tariff for WHD recipients, beginning in February 2018, does not cover all the vulnerable consumers we wanted to protect. In order to ready protections for some consumers this winter, we targeted a smaller group of consumers who suppliers can easily identify as vulnerable as a first step, rather than waiting until we can protect a larger group that is harder to identify. Given the uncertainty around the exact timing of the introduction of the government's market-wide price cap, we are concerned that some vulnerable consumers will not be protected during next winter. We therefore propose to implement our new safeguard tariff in late autumn 2018, if the government's market-wide price cap is not going to be in place before winter 2018-19.<sup>21</sup>
- 1.9. In our consultation on the safeguard tariff for WHD recipients, we considered a range of options to assist vulnerable consumers from paying more than they need to. We concluded that temporary<sup>22</sup> safeguard tariff protection was the

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<sup>16</sup> Households with direct-acting electric panel heaters that use standard single-rate electricity tariffs face significantly higher heating costs than households with storage heaters that use Economy 7 tariffs, or households with modern gas boilers. (See: Ofgem (2015) [Insights paper on households with electric and other non-gas heating](#), p. 13.). The Ofgem [Fuel Poor Network Extension Scheme](#) seeks to help fuel poor households that are not connected to the gas grid to switch to natural gas.

<sup>17</sup> In England, a consumer is defined as fuel poor if they have above average energy needs and paying for this amount of energy would leave them below the official poverty line. In Scotland and Wales, a consumer is defined as fuel poor if they would have to spend 10% of their income to achieve adequate standards of warmth (but the calculations differ). Government policies like the [Energy Company Obligation \(ECO\)](#) have sought to improve energy efficiency among certain consumers, in order to reduce their bills.

<sup>18</sup> Consumers in fuel poverty face similar risks of mental and physical detriment that other non-fuel poor vulnerable consumers can face. (See: Centre for Analysis of Social Exclusion (2012) [Getting the measure of fuel poverty](#), pp. 27-29).

<sup>19</sup> In our "[Financial protection for vulnerable consumers - technical document](#)" (p. 15) we highlight that for some consumers at risk of vulnerability (such as those with a disability or without internet access) we have not seen their switching and engagement levels increase in line with market-wide trends.

<sup>20</sup> As set out in our [Regulatory Stances](#) (see p. 8) we will act in the interests of vulnerable consumers who can't or don't engage in the market, and are at risk of poor outcome as a result. We may also act to reduce the cost to vulnerable customers if we believe they are suffering an unfair disadvantage.

<sup>21</sup> For more information on government's proposal see: BEIS (2017) [Draft Domestic Gas and Electricity \(Tariff Cap\) Bill](#)

<sup>22</sup> Making safeguard tariffs temporary ensures our measure is proportionate and in line with EU legislation.



most effective option for providing financial protection to vulnerable consumers as quickly as possible.<sup>23</sup>

1.10. We are proposing to extend safeguard tariff protection because we consider it is the most effective way of protecting more vulnerable consumers. Our objectives in developing this consultation are that any protection should:

- Be capable of rapid implementation (in time for winter 2018-19);
- Minimise unintended consequences for consumers and market distortions;
- Complement our wider market reforms by maintaining an incentive for consumers who are able to engage;
- Ensure that suppliers with efficient costs can compete; and
- Minimise the administrative burden and cost of implementation.

### **Duration of the vulnerable customer safeguard tariff**

1.11. If we decide to extend safeguard tariff protections, we expect that this protection would fall away when the government's market-wide price cap is introduced. Once the government's price cap is in place we will closely scrutinise outcomes for vulnerable consumers.

1.12. As part of the recently launched review of the supplier hub model,<sup>24</sup> we will also consider what default arrangements should be in place for all disengaged consumers, including the vulnerable. We are mindful that even if the conditions for effective competition are in place, it is likely that there will always be some vulnerable consumers who do not engage in the market and are therefore on a default deal. Before price protection is removed for these consumers, we will need to be confident that arrangements are in place to provide them with appropriate prices.

1.13. We also plan to revisit our 2013 Consumer Vulnerability Strategy over 2018-19. One of the outputs of this project will be to look into the assessment framework to identify market impacts and outcomes for vulnerable consumers.<sup>25</sup>

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<sup>23</sup> Ofgem (2017) [Financial protections for vulnerable customers – Technical document](#), chapter 3.

<sup>24</sup> Ofgem (2017) [Future of supply market arrangements – call for evidence](#).

<sup>25</sup> Ofgem (2017) [Draft Forward Work Programme 2018-19](#), p. 6.

## 2. Scope

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### Chapter Summary

In this chapter we explain which consumers we are seeking to protect with a safeguard tariff, and how we propose to identify them. We also set out our position regarding the tariffs, meter types and suppliers our proposal would cover.

**Question 1** – What are your views on our preferred approach of identifying consumers for safeguard tariff protection by primarily relying on data-matching?

**Question 2** – What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable consumers?

**Question 3** – Are there other methods for identifying vulnerable consumers that we should consider, either alongside or as an alternative to, our preferred approach?

**Question 4** – What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.

**Question 5** – What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?

- 2.1. Our Consumer Vulnerability Strategy (CVS) sets out our approach for how to identify and tackle vulnerability in the energy market. The CVS should therefore influence our thinking about which vulnerable consumers should be targeted for safeguard tariff support.
- 2.2. Under the CVS, we consider a consumer to be in a vulnerable situation when their personal circumstances and characteristics combine with aspects of the market to create situations where he or she is:
  - significantly less able than a typical consumer to protect or represent his or her interests in the energy market; and/or
  - significantly more likely than a typical consumer to suffer detriment, or that detriment is likely to be more substantial.<sup>26</sup>
- 2.3. This definition reflects our view that vulnerability stems from the wide range of situations which consumers can find themselves in, as a result of their characteristics and/or circumstances. The definition also reflects that risk factors of vulnerability can stem from personal characteristics and circumstances as well as from aspects of the energy market, such as the design and delivery of products and services. This all means that vulnerability is

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<sup>26</sup> Ofgem (2013) [Consumer Vulnerability Strategy](#), p. 12.

complex and multidimensional, and can also be transitory as people's circumstances change.

## Types of vulnerable consumers who need support

- 2.4. All elements of our broad CVS definition of vulnerability are relevant to determining which vulnerable consumers would benefit from safeguard tariff protection (see Figure 1 below).
- 2.5. Consumers can experience detriment if their vulnerable circumstances or characteristics lead to them being disengaged, and therefore less able to protect or represent their interests in the market. This puts these consumers at risk of potentially substantial detriment (see paragraph 1.6). We therefore consider **it is appropriate to provide temporary safeguard tariff protection to vulnerable consumers who cannot engage because of their circumstances and/or characteristics**,<sup>27</sup> or because it takes a disproportionate amount of time, effort or cost to do so.<sup>28,29</sup>
- 2.6. For some vulnerable consumers, we recognise that their vulnerability may not necessarily be the root cause of their disengagement, such as some consumers on a low income.<sup>30</sup> However, because they're disengaged, and subsequently paying high prices, a vulnerable consumer's circumstances or characteristics can put them at a higher risk of experiencing (potentially substantial) detriment. We are particularly concerned about the experiences for fuel poor<sup>31</sup> households who are disengaged and paying high prices.<sup>32</sup> **We consider fuel poor consumers are at a higher risk of experiencing detriment if they are disengaged and subsequently on an expensive default tariff deal.**
- 2.7. We recognise that non-fuel poor vulnerable consumers are also at a risk of detriment. Take the example of a financially well-off consumer who is on a

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<sup>27</sup> These consumers can include, but are not limited to, those: living with physical health issues or a mental illness; suffering from a cognitive impairment; having a learning disability; literacy or numeracy difficulties; having a speech impairment; or not speaking English as a first language. See: Ofgem (2013) [Consumer Vulnerability Strategy](#), p. 14.

<sup>28</sup> Consumer Focus and Citizen's Advice (2012) [Tackling Consumer Vulnerability, An action plan for empowerment](#), p. 11.

<sup>29</sup> In the [Consumer Vulnerability Strategy](#) (paragraph 3.12) we highlight that many types of biases impact how consumers behave in the energy market (such as loss aversion or status quo bias), and that some groups of vulnerable consumers are more susceptible to these biases. Our research into consumer attitudes shows that consumers who have vulnerable characteristics or circumstances are more likely to lack confidence, or to be wary of the potential risks of switching tariff or supplier. This includes consumers over the age of 65, with a low income, and living in rented social housing. See: GfK (2017) [Consumer Engagement in the Energy Market 2017: Report on a survey of energy consumers](#), p. 38.

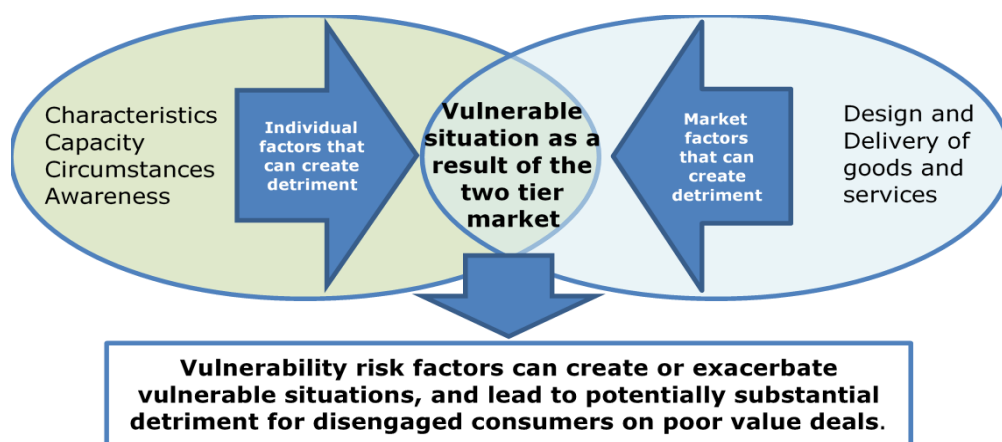
<sup>30</sup> In our [statutory consultation technical document](#) (paragraph 2.9) we discuss evidence showing consumers on incomes of less than £16,000 have shown a rate of switching growth in line with all consumers (11% to 15%), and a greater rate of growth in engagement (from 26% to 35%).

<sup>31</sup> In our [Consumer Vulnerability Strategy](#) (paragraph 3.19) we make clear that fuel poverty is a form of vulnerability that an energy consumer may face. The issues of "vulnerability" and fuel poverty" overlap, but importantly, the terms are not interchangeable.

<sup>32</sup> BEIS (2017) [Research into the Behaviours and Attitudes of the Fuel Poor in England](#), p. 35.

supplier's Priority Services Register<sup>33</sup> due to them having a long-term medical condition. This consumer could rely heavily on energy supply, and may not be willing to switch suppliers because they fear it will go wrong. This consumer's circumstances could cause their disengagement to be more embedded, and they could take longer to benefit from our other reforms. We consider that vulnerable consumers not on a low income, who can't or don't engage, are still at a higher risk of detriment and could benefit from temporary safeguard tariff protection.

**Figure 1: Types of vulnerable consumers who need support**



## Identifying the consumers who need support

2.8. To create a definition for a safeguard tariff, we looked to find suitable indicators which can be used to identify consumers who are vulnerable and have difficulty engaging in the market. These could include:

- Receipt of an income-related government benefit, excluding the standard state pension,<sup>34</sup> could be a reasonable proxy for fuel poverty. Individuals with low incomes are likely to spend a higher proportion of their income on energy than a typical consumer.<sup>35</sup> We recognise that this does not capture those who are fuel poor due to higher energy usage.

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<sup>33</sup> Under the Priority Services Register rules (standard condition 26 of the [electricity](#) and [gas](#) supply licences) suppliers are required to take all reasonable steps to identify consumers who may benefit from free non-financial services relating to safety, access and communication. The PSR rules provide a non-exhaustive list of personal characteristics that indicate a domestic customer could be vulnerable and might benefit from free, non-financial services. These characteristics include: being of pensionable age; being chronically sick, or having an impairment, disability, or long term medical condition (including but not limited to a visual, auditory or mobility impairment).

<sup>34</sup> We have excluded those who receive the standard state pension but no other benefits. Those receiving pension credits are included. See Appendix B.

<sup>35</sup> Ofgem calculations based on [Office for National Statistics data](#) show that, in 2015, the poorest 10 per cent of households spent an average of 9.7% of their income on energy, compared to 5.8% of their

## Providing financial protection to more vulnerable consumers

- Receipt of a disability-related government benefit may help to identify other vulnerable consumers. As outlined in chapter 1, analysis from the Competition and Markets Authority's (CMA) Energy Market Investigation and Ofgem's recent Consumer Engagement Survey has identified links between those living with a disability and vulnerability.<sup>36</sup>
- As we stated in chapter 1, our concern around disengagement is that the consumer is likely to be on a high-priced SVT. We therefore consider being on a default tariff to be a strong indicator of a lack of engagement in practice by the consumer.

2.9. We also believe the protection should apply automatically for eligible consumers, rather than requiring consumers to request it. It is likely that some of the most vulnerable consumers who are on default deals would be some of the least likely to contact their supplier.

2.10. Suppliers currently have three key sets of information that relate to vulnerable consumers:

- The **Warm Home Discount (WHD)**,<sup>37</sup> a rebate on energy bills provided by suppliers which supports low income and vulnerable consumers with energy costs because they receive particular income-related benefits.
- A **Priority Service Register (PSR)** maintained by each supplier, which enables vulnerable customers<sup>38</sup> access to free non-financial services relating to safety, access and communication (eg quarterly meter readings).
- **Consumers who are in debt or in arrears**<sup>39</sup> could be at a higher risk of being vulnerable if they have been in debt for a considerable period of time, or frequently fall in and out of debt. This could indicate they are on a low income and struggling to pay their bill.

2.11. These sets of information have weaknesses from the perspective of setting the scope for our safeguard tariff:

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income in 2005.

<sup>36</sup> We also note that there is research that explores links between disability and fuel poverty. For example, see: Thomson, Snell & Bevan (2013) [Fuel poverty and disability: a statistical analysis of the English Housing Survey](#).

<sup>37</sup> Full information on WHD can be found on our [website](#).

<sup>38</sup> Domestic customers eligible for the PSR include people who are of pensionable age; are disabled or chronically sick; have a long-term medical condition; have a hearing or visual impairment or additional communication needs; or are otherwise in a vulnerable situation.

<sup>39</sup> Consumers in arrears are Domestic Customers who are more than three months late in making a payment, but do not yet have a debt repayment arrangement set up. Consumers in debt are those with a debt repayment arrangement.

## Providing financial protection to more vulnerable consumers

- The WHD applies to two groups – a “Core Group” of consumers receiving the Guarantee Credit element of Pension Credit who receive the WHD automatically, and a “Broader Group” comprising people who receive certain other benefit payments (or who meet additional supplier-specific eligibility criteria), and who apply to their supplier for WHD.<sup>40</sup> There are two key issues:
  - The funding for Broader Group rebates is limited, and these rebates are paid on a first-come, first-served basis. Consumers in the Core Group are less likely to be in the poorest three income deciles than consumers eligible for the Broader Group.<sup>41</sup> The Broader Group may not receive WHD because the budget for rebates is capped.
  - In addition, WHD recipients only make up a proportion of those who could be considered vulnerable based on our indicators set out in paragraph 2.8 above. Based on the CMA’s survey, there are around 1.7 million WHD recipients on SVTs (including both prepayment and non-prepayment consumers<sup>42</sup>), whereas our latest estimate shows that there may be around 6 million households on SVTs containing at least one individual in receipt of income or disability-related benefits.<sup>43</sup>
- Consumers have to agree to be placed on the PSR, which may indicate at least some degree of engagement with their energy supplier. Alternatively some vulnerable consumers may not want to self-identify and would not be captured. The CMA’s survey found that consumers on the PSR were less likely than average to be on an SVT – though in some cases suppliers took steps to encourage PSR customers to move onto more favourable tariffs (we also note that the PSR definition has changed since the CMA’s survey was carried out).<sup>44</sup> The PSR focuses on whether customers require free non-financial services, rather than on whether they have low incomes. As this PSR information is collected by individual suppliers, there may be some differences between them.
- For those consumers in debt or arrears, in some instances, having difficulty paying bills could be a result of an acquired vulnerability (eg a stroke), a temporary vulnerability (eg a bereavement), or a permanent vulnerable situation (eg a lifelong medical condition requiring high energy use). We recognise the safeguard tariff protection may not be appropriate for

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<sup>40</sup> Core group customers receive their rebate if their supplier is a compulsory or voluntary scheme participant. Only obligated compulsory suppliers must provide rebates to the Broader Group.

<sup>41</sup> Income deciles based on After Housing Cost Equivalised Income.

BEIS (2016), [Warm Home Discount: Extension to 2016/17 and 2017/18, IA No: DECC0210](#), table A1.2

<sup>42</sup> Percentage of WHD consumers on SVTs from: CMA (2016), [Energy market investigation – final report, appendix 9.1](#), figure 41. Total number of rebates for 2015/16 WHD Scheme year from: Ofgem (2016) [Warm Home Discount annual report 2015-16](#), paragraphs 3.4 and 4.7.

<sup>43</sup> See Appendix B for an explanation of this estimation.

<sup>44</sup> CMA (2016) [Energy market investigation – final report](#), paragraphs 9.14 to 9.16

someone only experiencing temporary financial difficulty. However, someone who has been in arrears for an extended period (for example, at least three months) or is on a debt repayment plan would likely benefit from being on a safeguard tariff. We note that many consumers in debt may already receive price protection from the PPM safeguard tariff<sup>45</sup> and therefore these consumers would not receive additional protection as a result of our proposals.

- 2.12. We recognise that the way a consumer receives their energy from their supplier could also make them more likely to struggle to afford their energy bills. For instance, our research shows consumers who rely on electric heating are more likely to be fuel poor.<sup>46</sup> However, there could be challenges with identifying the estimated 2.2 million consumers without mains gas who use electric heating (of these consumers, we estimate around 1.5 million could be on a default deal).<sup>47</sup> This is because suppliers are unlikely to know whether the customer is, or is not, connected to mains gas. Although suppliers may be able to coordinate with gas distribution network operators, it could be challenging to do this in time for winter 2018-19. We also consider that vulnerable consumers without mains gas would be identified through our proposed approach (discussed below).

## Proposed way forward

### Preferred option – customers receiving government benefits

- 2.13. The government's WHD scheme identifies qualifying households using benefits data.<sup>48</sup> Under the scheme, a data-matching exercise is run with suppliers with over 250,000 consumers.<sup>49</sup> This provides the supplier with a flag that indicates whether a consumer meets the WHD "Core Group" eligibility criteria.<sup>50</sup> We consider this a highly effective way of identifying vulnerable consumers, as it does not require them to proactively contact their supplier about their vulnerability in order to receive safeguard tariff protection. Instead, it provides protection to disengaged vulnerable consumers automatically.
- 2.14. One option would be to apply the safeguard coverage to all those eligible for WHD, rather than just those who receive it (both the "Core" and "Broader Group"). We understand that government is not currently planning to extend

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<sup>45</sup> See Appendix D – Description of the prepayment methodology

<sup>46</sup> Ofgem (2015) [Insights paper on households with electric and other non-gas heating](#), p. 24.

<sup>47</sup> We have assumed most consumers without mains gas live in rural areas. CMA research indicate around 69% of these rural consumer are on a standard variable tariff. See: CMA (2016) [Appendix 9.1: CMA domestic customer survey results](#), p. 92.

<sup>48</sup> More information on the WHD scheme can be found on the [Ofgem](#) and [government](#) websites.

<sup>49</sup> Compulsory WHD suppliers include electricity suppliers who have 250,000 or more domestic customers, or who are part of a group of electricity or gas supply companies which together have 250,000 or more domestic customers.

<sup>50</sup> Data-matching does not occur for the consumers on the range of low income and disability benefits that would make them eligible for the WHD "Broader Group". More information on "broader-group eligibility criteria is included in Ofgem's [Warm Home Discount - Guidance for Suppliers](#) document (chapter 5).

data-matching under the WHD to all those eligible under the current “Broader Group” criteria. Therefore, an additional data-matching exercise would need to be run to allow suppliers to identify these fuel poor consumers so they can receive safeguard tariff protection. In addition, as stated above, we don’t think the WHD covers enough of those who could be considered vulnerable.

- 2.15. Therefore we think it would be better to develop our own criteria. Our current thinking is that this additional exercise could be based on consumers who currently receive an income or disability related benefit.<sup>51</sup> There is no precise data available, however we have approximated that data matching will allow us to protect around **2.2 million additional consumers on default deals**, who are not already protected by one of our planned or existing financial protections.
- 2.16. This approach will require a bespoke data-matching process between the Department for Work and Pensions (DWP) and suppliers to allow suppliers to identify consumers who receive an income or disability related benefit. The Digital Economy Act received Royal Assent on 27 April 2017. One strand of the Digital Economy Act facilitates the sharing of limited personal information within the public sector and to gas and electricity suppliers in order to protect those in fuel poverty (under the condition that other data protection and privacy obligations are met). To permit bespoke data-matching, we will need to work with the government to progress an amendment that includes safeguard tariffs as a measure listed in the Digital Economy Act.
- 2.17. This approach will also require suitable practical data matching arrangements to be in place, which could take time. Not only will new data-matching arrangements need to be established, but we will also need to explore what arrangements should be in place to enable consumers who are not successfully matched to raise queries and gain access to the safeguard tariff. We will continue working with the government to explore proposals for secondary legislation to amend the Digital Economy Act, and understand how all required data-matching processes can be expedited.
- 2.18. In order to deliver protection in time for winter next year, we consider that only suppliers obligated to participate in the WHD would be able to provide the safeguard tariff via data-matching. These suppliers have already satisfied the technical and operational requirements set by DWP and have arrangements in place to run the data-matching process.<sup>52</sup> The remaining suppliers would be required to use other existing proxies (as discussed in the backstop option below) to target vulnerable consumers. We discuss supplier scope in more detail in paragraphs 2.27 - 2.31 below.
- 2.19. Using government benefits as a proxy for vulnerability should capture many of the consumers that the other indicators seek to target. For example, many

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<sup>51</sup> A list of the benefits we are considering is set out in Appendix B.

<sup>52</sup> To data match for the WHD scheme, suppliers are required to demonstrate certain data security standards.



consumers in debt or in arrears may be receiving a low income benefit. Similarly, consumers without mains gas, and relying on electric heating, would also automatically be captured if they receive a government benefit that is data-matched. All consumers receiving a benefit that is data-matched would automatically receive safeguard tariff protection. For the suppliers that have data-matching, this approach would ensure that vulnerable consumers receive price protection on a consistent basis between those suppliers.

### **Backstop option – supplier-led targeting of vulnerable consumers**

- 2.20. Although the above data-matching approach is likely to more reliably identify vulnerable consumers, we recognise that it could be challenging to implement quickly. The data-matching option is also dependent on an amendment to legislation. We are therefore also considering a backstop approach. This would put responsibility on suppliers to identify, using information available to them, which of their consumers are most likely to be vulnerable, and place them on the safeguard tariff. This would build on the new requirements to identify vulnerable consumers under the domestic Standards of Conduct (standard condition 0).
- 2.21. In the absence of access to benefits data, suppliers could use other information about their customers that could indicate a risk of vulnerability. This includes whether a consumer is in debt or on the PSR, for example. We estimate that extending the safeguard tariff to these particular groups of consumers could provide protection to a slightly larger number of additional households as the data-matching approach (estimated to be an **additional 2.6 million consumers**), though the groups of individuals captured may be different.
- 2.22. We recognise that this option could not guarantee the same level of consistency between suppliers in terms of which consumers would be protected. Using the PSR as a flag for identifying vulnerable consumers could also exclude disengaged vulnerable consumers who have not self-identified as being in need of priority services.
- 2.23. Although the approaches to identifying vulnerable consumers through data-matching and supplier-held information are presented separately here, they need not be mutually exclusive. Supplier-held information could be used to expand the consumers in scope beyond consumers in receipt of benefits, and beyond suppliers who currently have data-matching capability.
- 2.24. Under either approach, we consider that eligible customers can be identified for the new safeguard tariff for winter 2018.
- 2.25. **We are interested to understand:**
- What are your views on our preferred approach of identifying consumers for safeguard tariff protection by primarily relying on data-matching?

## Providing financial protection to more vulnerable consumers

- What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable consumers?
- Are there other methods suppliers could use to identify vulnerable consumers that we should consider, either alongside or as an alternative to, our preferred approach?

### Other scope considerations

2.26. The section below summarises our proposals regarding the suppliers to whom extended safeguard tariff obligations should apply, the tariffs which would be in scope, the treatment of consumers with smart meters.

#### Suppliers in scope

2.27. In principle, we believe a vulnerable consumer should receive protection regardless of their supplier. Applying obligations to offer a safeguard tariff to some suppliers and not others could result in similar consumers getting different levels of protection depending on their supplier. However, although we want to ensure that eligible consumers do not lose out, the ability of different suppliers to carry out identification approaches will vary, depending on the indicators used.

2.28. Not all suppliers currently participate in the WHD scheme, which applies to electricity suppliers with over 250,000 domestic customer accounts and associated Scheme Gas Suppliers. However, the fifteen suppliers that are required to provide the WHD supply in excess of 93%<sup>53</sup> of the market. This means that these suppliers supply the vast majority of consumers and their share may be even larger among disengaged vulnerable consumers, who are by definition less likely to switch. Some smaller suppliers also participate in the scheme voluntarily.

2.29. As we set out above, **our current policy intention is to apply the vulnerable safeguard tariff to all suppliers**<sup>54</sup>. Ideally, all suppliers would use data-matching to identify vulnerable consumers for the safeguard tariff. However, it would take additional time for suitable arrangements to be put in place for non-WHD suppliers (currently over 40 suppliers) who need to prepare their systems for data-matching.<sup>55</sup>

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<sup>53</sup> Figure based on Ofgem analysis of gas and electricity distribution network operator reports. Information correct as of March 2017.

<sup>54</sup> Including white labels.

<sup>55</sup> Under current WHD scheme arrangements, we understand that suppliers who are undertaking data matching for the first time typically take six months to do this.

- 2.30. Therefore, we propose that only suppliers who are obligated to participate in the WHD scheme would be required to use the bespoke data-matching arrangements.<sup>56</sup> As indicated in paragraph 2.28, these suppliers represent the vast majority of the supply market. Therefore, taking an alternative approach for other suppliers is proportionate and feasible for winter 2018. The remaining suppliers could be required to use our backstop supplier-led approach.
- 2.31. While our aim is for all suppliers to participate fully, we recognise that some of the smallest suppliers may consider that the administration costs are disproportionately high. We welcome any evidence to demonstrate this. We will also consider the central administrative costs of data-matching for all domestic suppliers.<sup>57</sup>

## Tariffs

- 2.32. As stated previously we want to provide temporary safeguard tariff protection to vulnerable consumers who cannot engage because of their circumstances and/or characteristics, or because it takes a disproportionate amount of time, effort or cost to do so. As we stated in chapter 1, our concern around disengagement is that the consumer is likely to be on a high-priced SVT. We therefore consider being on default deals as a strong indicator of a lack of engagement in practice by the consumer.
- 2.33. We propose to use the same approach used for the WHD safeguard tariff taking effect in February 2018.<sup>58</sup> For this measure, we have opted to protect vulnerable consumers on standard variable or fixed-term default tariffs that are not captured by the existing prepayment meter safeguard tariff.
- 2.34. Another approach could be to target consumers who have been on a default deal for a specified period of time.<sup>59</sup> However, as we are seeking to assist vulnerable consumers who are at a higher risk of harm, we think it is right to provide these consumers with protection irrespective of how long they have been on a default tariff.

## Meter type

- 2.35. Consistent with the initial WHD safeguard tariff, we propose that our extended safeguard tariff protections would apply regardless of meter type. We consider

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<sup>56</sup> We currently do not propose to place WHD Voluntary Suppliers in scope at first. We understand these suppliers can have data matching processes in place. However, if we included them in scope, they might choose to withdraw from participating in WHD, which could lead to a loss of consumer benefits.

<sup>57</sup> [Ofgem data](#) shows there were 60 active domestic suppliers as of June 2017.

<sup>58</sup> Ofgem (2017) [Statutory consultation for a vulnerable customer safeguard tariff](#), p.4.

<sup>59</sup> For example, the CMA's database remedy seeks to engage consumers who have been on a SVT deal with the same supplier for three years or more.

it is appropriate to provide assistance to vulnerable consumers on default deals, irrespective of what meter they have.<sup>60</sup>

2.36. We note that this position is different to the prepayment safeguard tariff, which will not apply to those consumers who receive fully interoperable smart meters. The CMA introduced the prepayment safeguard tariff to mitigate the lack of competition for customers on non-smart prepayment meters. In contrast, we are seeking to ensure that vulnerable consumers who have not engaged are protected – no matter what meter they have.

**2.37. We are interested to understand:**

- What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.
- What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?

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<sup>60</sup> Ofgem (2017) [Statutory consultation for a vulnerable customer safeguard tariff](#), p. 5.

## 3. Methodology

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### Chapter Summary

This chapter sets out our current thinking on the methodology options available for setting the vulnerable customer safeguard tariff level given the time available. We also consider potential design issues.

**Question 6:** Which of our two options for setting the benchmark component of the safeguard tariff would be most effective?

**Question 7:** Do you have any comments on the design issues for either of our two options?

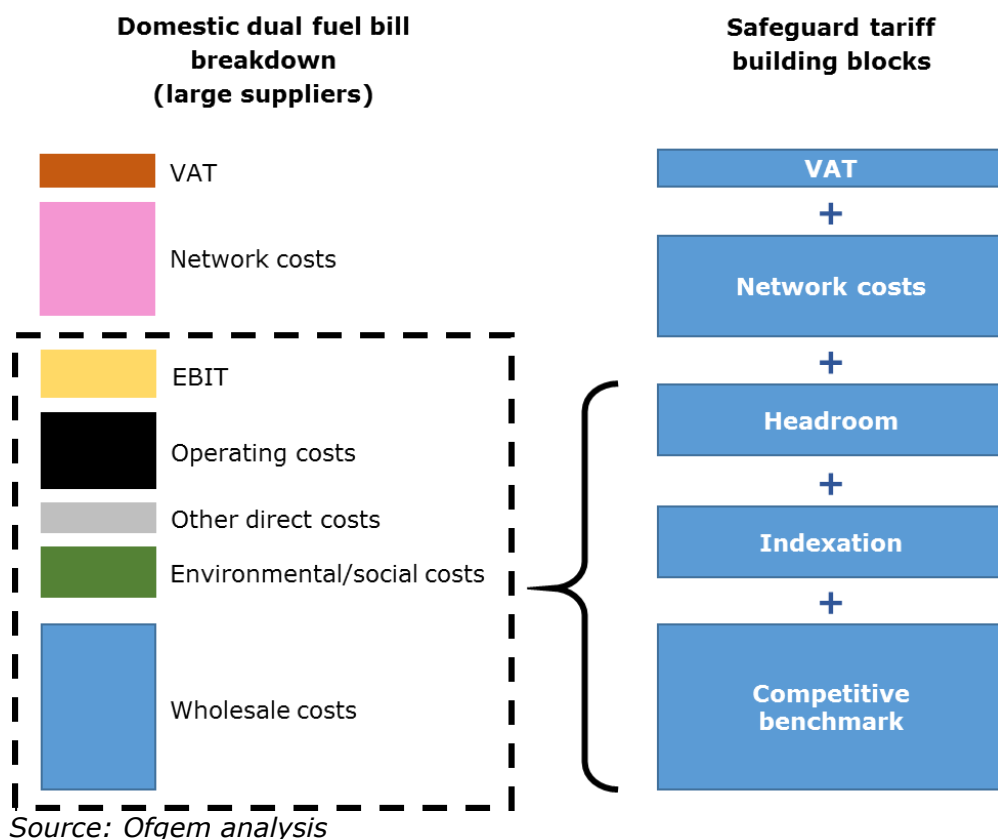
### Approach to setting the safeguard tariff level

- 3.1. The current prepayment safeguard tariff (which, from February 2018, will be extended to those consumers who receive Warm Home Discount (WHD) rebate) is composed of a number of separate components, as shown in Figure 2 below.
- 3.2. The main components of the prepayment safeguard tariff are:
  - a competitive benchmark (based on the average direct debit price of two mid-tier suppliers in 2015, with adjustments<sup>61</sup> and an uplift for the additional costs of serving prepayment customers);
  - an allowance for headroom to enable suppliers to offer competitive deals beneath the level of the safeguard tariff;
  - indexation to allow for changes to wholesale, policy (environmental/social) and other external costs; and
  - an allowance for network charges.

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<sup>61</sup> See Appendix D for a more detailed description of the competitive benchmark and the Competition and Markets Authority's (CMA) prepayment methodology.

**Figure 2: Components of the prepayment safeguard tariff**



3.3. The competitive “benchmark” which we use to set the safeguard tariff is a key design consideration. The methodology for establishing the benchmark is important because it needs to ensure the safeguard tariff is set at a level which reflects the price that an efficient supplier would charge in a competitive market. It should not be set too high such that it offers little protection to consumers, but it should also not be set too low and prevent suppliers from recovering costs which are incurred efficiently.

3.4. Our assessment builds on our considerations when setting the WHD safeguard tariff.<sup>62</sup> First, we considered what benchmark options would offer effective financial protection to vulnerable consumers. This included an assessment of whether the methodology could be designed to:

- reflect efficiently incurred costs without being influenced by the behaviour of suppliers;
- facilitate a degree of competition under the safeguard tariff level and provide an incentive for consumers to engage with the market;
- minimise distortions to competition and any other unintended consequences; and

<sup>62</sup> Ofgem (2017) [Financial protections for vulnerable customers – Technical document](#), Chapter 3.

- ensure that the costs of administration, monitoring and compliance are proportionate and not overly burdensome.
- 3.5. Second, we considered how quickly each benchmark methodology could be established and the likely implications of each on our objective to extend safeguard tariff protection to a wider group of vulnerable consumers by winter 2018-19.
- 3.6. We note that in order to implement a safeguard tariff by next winter, we would need to issue a statutory consultation in spring 2018. This means that we will need to have developed our final proposals on all elements of the methodology by that point.
- 3.7. There are a range of approaches to set the benchmark. Building on our previous work,<sup>63</sup> we identified and considered five in detail. These were:
- (i) **Prepayment methodology – based on the CMA benchmark.** This approach is based on the underlying methodology used to calculate the prepayment safeguard tariff and which we subsequently decided to use as a temporary solution for the WHD safeguard tariff. The benchmark is based on the prices of two mid-tier suppliers observed by the CMA in 2015 (with adjustments), and is updated every six months using an index of external costs over which suppliers have no influence. Where appropriate, we may consider whether there are methodological changes which could improve the benchmark or other aspects of the design within the time available.
  - (ii) **Prepayment methodology – recalculated benchmark.** This approach would also be based on the high-level approach used to calculate the prepayment safeguard tariff, but would instead use an updated benchmark established by Ofgem. An updated benchmark could be based on the CMA approach of using the prices of two mid-tier suppliers, or could use a different approach.
  - (iii) **Basket of market tariffs.** This approach would calculate the benchmark based on a basket of tariffs available in the market at a given point in time (meeting certain criteria, eg cheapest). We would collect information on these tariffs at regular intervals to ensure that changing market conditions were reflected in the safeguard tariff.
  - (iv) **Bottom-up cost assessment.** The basis of this approach would be to develop a 'bottom-up' view of the costs that would be incurred by an efficient supplier. The safeguard tariff would be set to enable this 'notional' supplier to recover these costs and make a return.

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<sup>63</sup> See Ofgem (2017) [Financial protections for vulnerable consumers – technical document](#), chapter 3.

- (v) **Regulated "default tariff"**.<sup>64</sup> This approach would establish a new tariff which would be mandatory for all suppliers. The tariff would be composed of a set of "exogenous" components, covering the costs of generation, networks, taxes and levies. Suppliers would only be able to recover amounts in respect of these items up to a cap set by Ofgem. Suppliers would have discretion to charge their own "supply margin" on top of these costs to reflect the cost of delivering their supply activities and making a return, although we would also set a maximum cap on the supply margin.

### Benchmark methodology

- 3.8. We carried out an assessment of the various approaches listed above and concluded that implementing the recalculated prepayment methodology, bottom-up cost assessment or regulated default tariff proposal (options ii, iv and v above) would not be possible in the time available. This is due to the additional policy development, data collection and analysis necessary to develop these novel and complex methodologies.
- 3.9. If rapid implementation of the safeguard tariff was not one of our main objectives, we would give further consideration to the full range of approaches. But, given the need to extend the safeguard tariff to a wider group of vulnerable consumers by winter next year, we are limited to options we can feasibly implement in the time available.
- 3.10. Therefore, **we are only seeking views on two of the options presented above: (i) the prepayment methodology based on the CMA's benchmark and (iii) the basket of market tariffs.**
- 3.11. At this stage we have more experience with the prepayment methodology, but we currently consider that both options could potentially be designed so that the methodology would reflect efficient costs, allow for suppliers to compete, and ensure that suppliers were not able to 'game' the tariff through their own actions.
- 3.12. We consider that these could both be proportionate options for a safeguard tariff which would be in place for a relatively short period of time (until the introduction of the government's proposed market-wide SVT and default price cap), and which would cover around 3 million households.<sup>65</sup>

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<sup>64</sup> The regulated default tariff option is taken from the proposals put forward by Professor Dieter Helm as part of the [Cost of energy: independent review](#).

<sup>65</sup> This figure includes around 1 million households who will be protected by the initial WHD safeguard tariff.



*The prepayment methodology based on the CMA benchmark*

- 3.13. One of the benefits of the prepayment methodology based on the CMA benchmark is that the CMA's objectives when it was designing the prepayment meter safeguard tariff are very similar to our own objectives. For example:
- the benchmark is based on competitive prices (with adjustments), to enable efficient suppliers to compete and minimise unintended distortions;
  - the tariff is updated over time using an index of exogenous costs which cannot be affected by the behaviour of an individual supplier, ensuring that suppliers retain an incentive to become more efficient;
  - the methodology also includes a headroom allowance, which is intended to maintain some incentive for consumers to engage with the market and to encourage suppliers to compete; and
  - it offers immediate protection for eligible consumers currently on more expensive default tariffs by setting a maximum charge based on the benchmark.
- 3.14. Considering our experience in the implementation of the prepayment methodology, we are confident that it could be designed to minimise any distortions to competition or other unintended consequences. Additionally, suppliers are already familiar with the prepayment methodology, so this approach would reduce the costs of monitoring and compliance with the tariff.
- 3.15. The downside of setting the safeguard tariff in this way is that the indices and suppliers' actual efficient costs may diverge over time. This would mean that the safeguard tariff could either become too tight (not allowing suppliers to recover efficient costs) or too loose (failing to deliver the same level of protection to consumers over time). However, this concern is mitigated because we are only proposing to extend the safeguard tariff to a minority of consumers and because this version of the safeguard tariff would only be in place until the government's wider price cap came into effect.
- 3.16. Some suppliers have concerns about the prepayment methodology and particularly the CMA's benchmark. We discuss these in the Design Issues section later in this chapter. As we stated before, we will not be able to implement fundamental changes to the prepayment methodology in the time available.

*Basket of market tariffs*

- 3.17. Using a basket of market tariffs could be a credible alternative in the time available because it would be based on, and updated in line with, actual market prices. This removes the need for regular adjustments to reflect changes in costs, involving assumptions, estimates and approximations.
- 3.18. Using a basket of market tariffs would also reduce (but not eliminate) the role for analysis and judgement in setting the safeguard tariff, compared to the

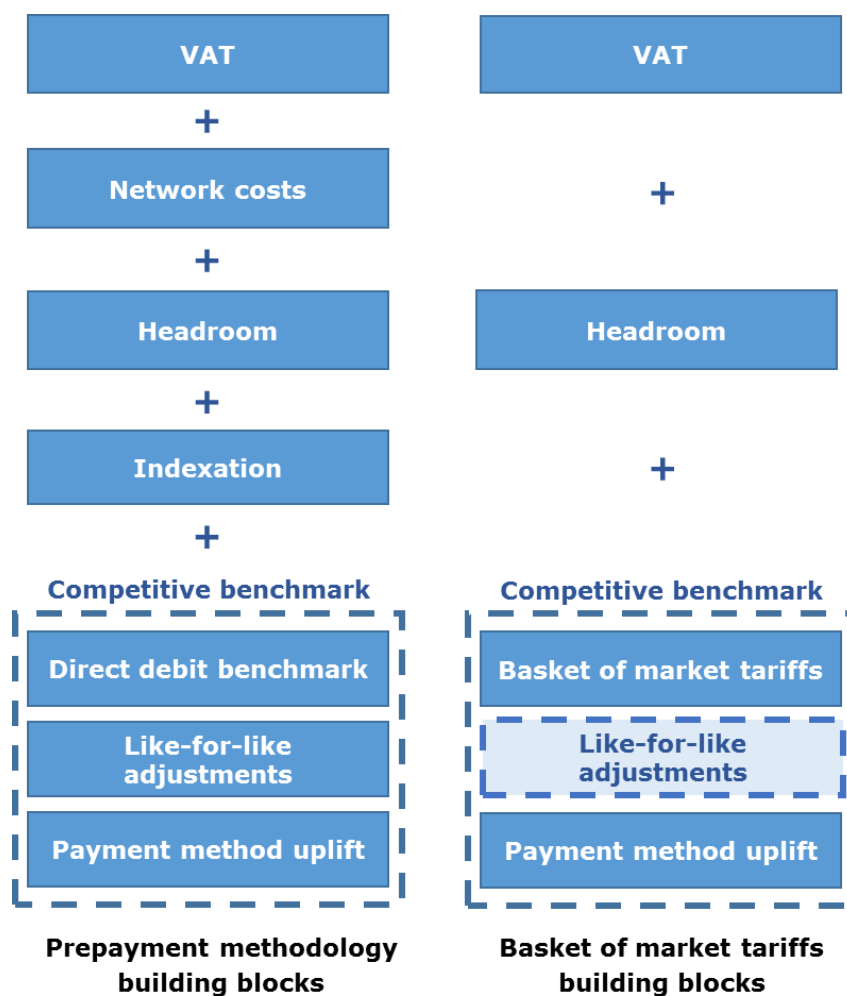
prepayment methodology. This could reduce upfront administrative costs, though there would potentially still be an ongoing administrative cost to keep the basket up to date.

- 3.19. The adequacy of the basket approach depends on the tariffs included. It could comprise the cheapest tariffs in the market.
- 3.20. However, there could be a number of reasons why the cheapest tariffs in the market do not represent the efficient level of costs. For example, a smaller supplier in the basket might be exempt from certain policy costs, and its prices might therefore not reflect the costs of an efficient larger supplier who did not benefit from the same exemptions. It is also plausible that new entrants to a market will offer low prices in order to build scale and brand awareness. These prices may or may not be sustainable in the long-run. A supplier might also be able to offer a lower price if it was not spending enough money to offer adequate customer service. Incorporating such tariffs in the benchmark could risk 'hollowing out', where other suppliers reduce the quality of service to vulnerable consumers in order to reduce their costs and meet the safeguard tariff, or could result in suppliers significantly raising prices on other (non-capped) tariffs.
- 3.21. However, if we consider that this is a risk, and that the basket would underestimate the efficient level of costs, we could address this in the level of headroom above the benchmark, or a separate uplift.
- 3.22. If designed appropriately, the benchmark would be outside of the control of any individual supplier. This would ensure that suppliers retain incentives to set cheap tariffs to compete for engaged customers and become more efficient.
- 3.23. The ability of suppliers to influence the basket would mainly be driven by the number of tariffs and number of tariff observations used. We consider that it is possible to design such a basket, but are mindful that this approach has not been used in the UK before.

## Design issues

- 3.24. The level of the safeguard tariff will need to be carefully calibrated if it is to provide effective protection to vulnerable consumers while meeting our other objectives.
- 3.25. Building on the benchmarking approaches described above, Figure 3 below illustrates the main components of the tariff design and how they might differ between the two methodologies. We note that we will need to provide further consideration to how network costs will be accounted for in any basket of market tariffs approach, to ensure regional variations are accurately accounted for.

**Figure 3: Comparison of prepayment approach and basket of market tariffs – building blocks**



3.26. Under the prepayment methodology, the competitive benchmark is based on the direct debit prices of two mid-tier suppliers observed by the CMA in 2015, with “like-for-like” adjustments to ensure that the benchmark is comparable to the prices of other suppliers, including larger suppliers. In addition, the competitive benchmark includes an uplift to allow for the additional costs incurred in serving different customer groups depending on their payment method. The competitive benchmark is updated every six months using an index of external costs.

3.27. Under the basket of market tariffs methodology, the competitive benchmark is based on a basket of tariffs available in the market at a given point in time meeting certain criteria (eg cheapest). If we consider that there is a risk that the cheapest tariffs in the market would underestimate the efficient level of costs, the benchmark may require a separate “like-for-like” adjustment, or we could address this in the level of headroom above the benchmark. The basket of market tariffs would also differ from the prepayment methodology in that the benchmark would be updated at regular intervals based on actual market prices.

3.28. In this section we first explain those design issues which are common to both benchmark methodologies, and then consider issues which are specific to each methodology. We would like to hear views on all of the issues in this section. If stakeholders have evidence regarding further design issues, we would welcome these as well.

### **Common design issues**

#### *Defining benchmark consumption*

3.29. To scale the safeguard tariff level relative to consumption, we need to set the benchmark for at least two different levels of consumption. In the CMA's prepayment methodology, the benchmark was set at nil consumption and at the Typical Domestic Consumption Value (TDCV). Providing a benchmark for the safeguard tariff level at nil consumption and at the TDCV allows suppliers to calculate the maximum charge for different rates of consumption, and therefore the implied maximum standing charge per day, and the implied maximum unit rate for simple tariffs.

#### *Benchmark at nil consumption*

3.30. The prepayment safeguard tariff at nil consumption (equivalent to a standing charge) was calculated based on the prepayment standing charges set by the six large energy suppliers. This may not be appropriate for the vulnerable safeguard tariff because our target group of customers will generally not have a prepayment meter.<sup>66</sup> Therefore, under either benchmark approach we will need to decide whether to amend the approach to setting the safeguard tariff at nil consumption.

3.31. One option would be to retain the prepayment methodology standing charge value. This would be simple, but might not reflect the fixed costs associated with other payment methods.

3.32. As another option, we could obtain the direct debit benchmark at nil consumption by subtracting the prepayment method uplift value from the value of the prepayment safeguard tariff at nil consumption (before adding back a payment uplift as appropriate – see paragraphs 3.39 – 3.49). This would also be simple to calculate, but would be an indirect way of estimating the benchmark for non-prepayment customers.

3.33. Alternatively, we could calculate it in a similar fashion to the CMA, by requesting data from the six large energy suppliers (or other suppliers) on their

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<sup>66</sup> The only prepayment customers in scope would be those with a fully-interoperable smart meter, who would therefore fall out of scope of the prepayment safeguard tariff.

direct debit standing charges, as well as the number of consumers for weighting purposes.<sup>67</sup>

- 3.34. We could also calculate the benchmark at nil consumption using the standing charges of the tariffs included in the market basket.
- 3.35. We know that low use consumers benefit from lower standing charges. Some groups at risk of vulnerability may have low consumption (eg those living alone), but some vulnerable consumers use high volumes of energy because of ill health, small children or poor quality housing stock. This means that we would only introduce a deliberately low standing charge if we were presented with strong evidence that this was particularly beneficial for our target group.

#### *Benchmark at Typical Domestic Consumption Value*

- 3.36. The prepayment methodology calculates a reference level for the cap at the median typical level of domestic consumption (known as the TDCV) using competitive benchmarking analysis.
- 3.37. If we retain the prepayment methodology based on the CMA benchmark, there would not be any scope to change this element of the methodology, because the benchmark was set at the historical TDCV.
- 3.38. However, if we decide to calculate the benchmark based on a basket of market tariffs, we could adopt a different approach whereby the benchmark is set at a level of consumption which is not the historical TDCV. For example, we could use the current TDCV.<sup>68</sup>

#### *Payment method uplifts*

- 3.39. As explained in paragraph 3.2, the prepayment methodology includes the cost to the supplier of serving prepayment customers, as an uplift above the direct debit benchmark. We recognise that eligible customers under the vulnerable customer safeguard tariff will be primarily split between direct debit and standard credit payment methods.
- 3.40. There is likely to be a difference in the costs associated with serving prepayment and standard credit customers for an efficient energy retailer, compared with direct debit customers. In the case of supplying standard credit customers, the CMA found that this is primarily driven by bad debt and working capital costs. The CMA estimated a cost differential of around £100 between

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<sup>67</sup> If we were adopting the prepayment safeguard tariff benchmark, we would use data from 30 June 2015, to be consistent with the data used to calculate the benchmark at the median TDCV. If we were using the basket of tariffs approach, we might choose a more recent date instead.

<sup>68</sup> We last updated the level of the [Typical Domestic Consumption Values](#) in August 2017.

direct debit and standard credit for a dual fuel customer.<sup>69</sup> We note that there are various approaches to assessing the cost differential between payment methods which could plausibly provide very different estimates. The cheapest standard credit dual fuel tariff in the market is currently around £130 per year more expensive than the cheapest direct debit dual fuel tariff.<sup>70</sup>

- 3.41. **There is a policy question around whether it is appropriate to have multiple safeguard tariff levels to reflect the costs of different payment methods, or whether to have a common level based on a “blended” uplift.**
- 3.42. Using different uplifts (and therefore safeguard tariff levels) could reflect costs more accurately, and help to ensure that efficient suppliers are able to cover their costs for each type of payment method.<sup>71</sup> However, as noted above, there are questions about the extent to which costs can be fully attributed to different payment methods, rather than reflecting a cost allocation choice by suppliers. This option would also mean administering double the number of safeguard tariff levels, which could be more complex and costly.
- 3.43. Using a single blended uplift, and assuming the cost differential between direct debit and standard credit payment methods is significant and the uplift is set between the two, standard credit customers will benefit relative to those paying by direct debit.
- 3.44. The next question is about **how to set the payment uplift value.**
- 3.45. One option would be to reuse either the prepayment or the standard credit values calculated by the CMA in 2015. These were generated following significant analysis and have already been subject to consultation. There is no reason to expect these uplifts to have changed significantly over the intervening period. This would be a relatively simple and light-touch approach that would require minimal analysis.
- 3.46. If we decide to apply the same payment method uplift to all eligible customers, the prepayment uplift could be an appropriate approximation of the costs to serve a mix of direct debit and standard credit customers, as it is below the standard credit uplift. However, it would not precisely reflect the mixture of payment methods (and consequent costs) for consumers in scope for this safeguard tariff.

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<sup>69</sup> CMA (2016), [Energy market investigation – final report, appendix 9.8](#), paragraph 8.

<sup>70</sup> Figures are published on the [Ofgem data portal](#).

<sup>71</sup> Efficient suppliers would therefore cover their costs of supplying consumers in scope, regardless of the particular mix of payment methods their customers use.

- 3.47. If we decide to implement separate safeguard tariffs for direct debit and standard credit customers, we could reuse the standard credit uplift calculated by the CMA.
- 3.48. Alternatively, we could recalculate the payment method uplift for standard credit. The CMA said that “the information supplied to us provided a wide range of results”<sup>72</sup> – in theory, it might therefore be possible to produce a refined estimate for the payment method uplift. This might be worth attempting, given that the current estimate is a significant amount (£100 for a dual fuel customer). Any inaccuracies could therefore affect the balance between protecting consumers and ensuring that suppliers can cover efficient costs. It could also have an impact on suppliers’ incentives to serve customers on different payment types, or to move them onto a lower cost payment type. However, this would require significant information gathering from suppliers, particularly about bad debt and working capital. Even with this information, there is no guarantee that we would be able to develop a better estimate. We welcome views on whether or not recalculating this should be treated as a priority.
- 3.49. In the future we would potentially also need to consider whether a specific payment method adjustment would be required for prepayment customers with fully interoperable smart meters.<sup>73</sup> Smart meters may enable a lower cost to serve than the prepayment uplift, but it is possible that there may still be specific costs to serve for prepayment customers. It could be challenging to calculate a specific payment method uplift for these customers, as there will be limited data available. For this safeguard tariff, we would not propose to calculate a specific uplift for this limited group of customers.

## Headroom

### *The role of headroom*

- 3.50. As set out in our regulatory stances, our general view is that a competitive market is the best way to protect and promote consumers’ interests.<sup>74</sup> The prepayment methodology includes a “headroom” component, which (as shown in Figure 2) is an increment between the competitive benchmark and the level of the safeguard tariff. The primary role of headroom is to preserve the desirable characteristics of a competitive, well-functioning retail energy market by allowing suppliers to compete for customers by charging different prices below the safeguard tariff level.

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<sup>72</sup> CMA, [Energy market investigation - Final report, appendix 9.8](#), paragraph 8.

<sup>73</sup> These meters are excluded from the prepayment safeguard tariff. However, these have yet to be installed in significant numbers.

<sup>74</sup> Ofgem (2016) [Ofgem Regulatory Stances](#).

- 3.51. Price differentials provide some of the necessary incentives for consumers to engage in the market. In line with our Consumer Vulnerability Strategy, we want to ensure that vulnerable consumers have equal access to the market and we seek to empower consumers in vulnerable situations, as well as to protect them. However, we recognise that there may be other factors (as discussed in the Financial protections for vulnerable consumers - technical document<sup>75</sup>) that mean that some vulnerable consumers will still find it difficult to engage.
- 3.52. While engagement is currently lower than average among several groups at risk of vulnerability, there may be some potential for engagement to improve over time for at least some vulnerable consumers in response to changes like the smart meter roll-out. We want vulnerable consumers to benefit from the future smarter market and engagement will be important to deliver this.
- 3.53. Headroom ensures that there is room for suppliers with different service propositions and cost structures to co-exist when serving vulnerable consumers. For example, without headroom, a supplier would not be able to charge more for a higher (and more costly) service level. This could reduce the diversity of business models and reduce benefits for consumers, although we note that suppliers would remain free to offer a higher service level to vulnerable consumers on fixed-term tariffs, as well as to other consumers.
- 3.54. Technological change will also create scope for innovation in business models and energy tariff offerings. These changes mean that it will become increasingly important to ensure that there are both incentives for consumers to engage in the energy market, and incentives and flexibility for suppliers to innovate. Allowing for innovation necessarily means allowing for engagement, as consumers who are no longer incentivised to switch are unlikely to shop around for better products.
- 3.55. There will always be a number of uncertainties and approximations involved in setting a safeguard tariff which reflects the costs of an efficient supplier. These uncertainties will affect both the overall level of these costs, but also how costs vary across consumer groups and over time. If these uncertainties unintentionally lead the safeguard tariff to be set below the costs of an efficient supplier, then this would lead to suppliers making a loss when supplying vulnerable consumers. The risk of this leading to suppliers exiting the market may be limited if the safeguard tariff only applies to a small group of consumers – although it could contribute to exit decisions (for example, if suppliers perceived that there was significant regulatory uncertainty). More importantly, it could affect suppliers’ incentives to gain or retain vulnerable consumers.
- 3.56. There is a risk that suppliers decide to set all their prices at the maximum level allowed by the safeguard tariff. This would, in effect, negate the benefit of headroom. However, we think, given the large number of suppliers in the

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<sup>75</sup> Ofgem (2017) [Financial protections for vulnerable consumers – Technical Document](#), paragraph 2.12



domestic retail market, that they will continue to compete for new customers by pricing below the level of the safeguard tariff, especially given that the majority of consumers in the market would remain outside this safeguard tariff.

3.57. Therefore, our provisional view is that there is a strong case to retain a headroom component in the safeguard tariff.

#### *Format of the headroom*

3.58. The prepayment methodology has a headroom level set as a percentage figure fixed over the life of the tariff. It has separate levels for electricity and gas, fixed across all suppliers. This percentage is applied to all elements of costs except the network allowance, and means that the absolute value of headroom varies over time according to indexation movements (see Appendix D for a full explanation). These were initially intended to deliver headroom of £30 for a dual fuel customer at typical consumption.<sup>76</sup> We discuss other ways of setting the headroom below – however, at this stage we do not think these would be an improvement. Our current proposal is therefore to set headroom in the same way as the prepayment methodology.

3.59. One alternative would be to set the headroom level based on an absolute figure instead of a percentage. This initial headroom level could then be indexed and updated over time based on a headroom specific index. Since we are not aware of an objective index which would be appropriate for this task, we consider that this approach would make the methodology more uncertain and undermine the effectiveness of the safeguard tariff. This would also be more onerous than the percentage level given that it would be another index to update.

3.60. Instead of having a consistent headroom allowance across all suppliers, a further option would be to set headroom for each individual supplier to reflect differences in aspects of the service offering. For example, suppliers with higher levels of customer service could be set a larger amount of headroom. However, we think that it would be hard to develop a suitable methodology in time for this safeguard tariff, but we might consider this with respect to the market-wide price cap.

#### **Design issues specific to the CMA prepayment methodology**

3.61. Some design issues are only relevant to the CMA prepayment methodology. We discuss the costs of the smart meter roll-out and the costs of implementing government actions to decarbonise the energy sector (which we term “policy costs”) in turn below.

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<sup>76</sup> CMA, [Energy market investigation - Final report](#), paragraph 14.253.

### *Smart meter costs*

- 3.62. In response to previous consultations, several suppliers have suggested that the prepayment methodology understates costs relating to the smart meter roll-out. The submissions we have received to date suggest that these concerns relate to both the initial amount of smart costs included in the benchmark and the approach to indexation.
- 3.63. The prepayment methodology implicitly includes costs and benefits of smart metering in the benchmark – the then Department for Energy and Climate Change told the CMA that this was due to the “substantial smart meter populations and associated investment by the energy suppliers that informed the benchmark bill”.<sup>77</sup>
- 3.64. Some suppliers have suggested that, as an additional cost, the charges associated with the Data Communications Company (DCC)<sup>78</sup> should be incorporated into the methodology and managed as a pass-through cost going forward. For example, the DCC fixed charge could be removed from the benchmark and updated in line with published charging statements, as currently happens for network charges. The effect would be to increase the level of the safeguard tariff. We welcome views on whether and how the methodology should take DCC charges into account.
- 3.65. In terms of indexation, the prepayment methodology allocated smart costs to the category of ‘other costs’ which are indexed in line with the Consumer Prices Index (CPI). A different indexation approach would require an understanding of the proportion of initial ‘other costs’ that should be allocated to smart metering, taking account of both the costs and savings that suppliers see from smart metering. There would then need to be a suitable exogenous index (eg to take into account the number of smart meters installed). We welcome views on whether or not an adjustment in the approach to indexation is necessary, and whether it would be practicable in the time available.

### *Policy costs*

- 3.66. Some suppliers have raised the Energy Intensive Industries exemption from certain policy costs.<sup>79</sup> Whilst these policies were not directly reflected in the prepayment benchmark, the CMA did consider the effect of the exemption for the Renewables Obligation and Feed-in Tariffs. It also considered the effect of indexing Energy Company Obligation (ECO) costs using the policy cost index, because ECO costs were not expected to grow like overall policy costs. It

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<sup>77</sup> CMA, [Energy market investigation - Final report](#), paragraph 14.237.

<sup>78</sup> The DCC is a central communications body appointed to manage communications and data transfer for smart metering.

<sup>79</sup> Energy-intensive industries are exempt from the costs of the Renewables Obligation and Contracts for Difference policies. The costs of these schemes are instead recovered from non-exempt customers. The government has also proposed an exemption from the costs of Feed-in Tariffs.

concluded that these two factors would largely offset each other (the policies were separate, but had opposite effects on the costs to domestic energy suppliers).<sup>80</sup> Our provisional view is that we will adopt the same position as the CMA unless there is particularly compelling evidence that the costs are not offset by ECO.

### Design issues specific to the basket of market tariffs

3.67. In order to provide immediate and ongoing protection to vulnerable consumers while reflecting suppliers' efficient costs, we need to consider a range of factors in the design of the basket. For example:

- **The number of tariffs in the basket.** This should be large enough to reduce the risk of individual suppliers being able to influence the safeguard tariff level through their pricing decisions, but not so large that it reduces the protection it provides to vulnerable customers. We provisionally think that a basket of ten tariffs might strike a suitable balance. This would avoid a situation where individual tariffs made up over a tenth of the basket – but would still ensure that the basket focused on the cheapest fraction of tariffs.
- **Structure of basket.** There may be a justification for excluding certain tariffs from the basket. As noted in paragraph 3.20, the cheapest tariffs in the market might not represent all the costs of an efficient supplier. One approach would be to exclude the cheapest tariffs from the basket to reduce the impact of any outliers – for example, setting the benchmark based on the 6<sup>th</sup> to 15<sup>th</sup> cheapest tariffs, rather than the ten cheapest. We may also want to exclude certain tariffs with limitations on availability. These could include online only/paperless tariffs, and acquisition only tariffs. That said, we may conclude that this level of complexity is not necessary, and that the basket would be suitable without exclusions. There may be other ways of addressing this issue, such as an additional standardised allowance for any costs that are not covered by the tariffs in the basket, though again this would add complexity.

Other issues we may wish to consider are:

- **Tariff duration.** Only including tariffs with a specific duration (eg one year fixed-term) might ensure a more consistent projection of costs and make it easier for suppliers to hedge in line with the tariffs in the basket, but could create opportunities for gaming.

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<sup>80</sup> CMA, [Energy market investigation - Final report](#), paragraphs 14.214 to 14.222. We note that this does not refer to the impact of the Energy Intensive Industries exemption from the Contracts for Difference scheme. However, BEIS previously estimated that this would only cost £1 per household per year in 2018/19. (BEIS (2017), [Energy Intensive Industries \(EIIs\) – Exemption from the indirect costs of Contracts for Difference \(CfD\). Government response to consultation](#), annex B.)

- **Tariffs per supplier.** Including only one tariff per supplier could affect the influence that any one supplier could have over the basket, but might make the basket less representative of the most competitive tariffs in the market.
- **Supplier size.** There could be a minimum threshold on the number of customer accounts signed up to the supplier. This might ensure that the basket includes most or all of the policy costs incurred by larger suppliers, but could reduce the extent to which the basket reflects the most competitive tariffs in the market. Alternatively, it might be possible to design a separate adjustment for policy costs.
- **Approach to single fuel baskets.** These could be based on the same prices used to calculate the dual fuel basket. Alternatively, separate single fuel baskets could be calculated. We provisionally think that the former approach would be simpler.

**3.68. We welcome any comments on the design issues for either of our two options.**

### Updating the safeguard tariff over time

3.69. We consider that the safeguard tariff needs to be updated over time in a way which helps to deliver a consistent degree of protection for vulnerable consumers over time, whilst also ensuring that efficient suppliers can recover their costs. Our position on how the safeguard tariff would be updated would likely depend on the benchmark approach we adopt.

### Updating the prepayment methodology over time

3.70. The prepayment methodology was designed such that the safeguard tariff level is updated to account for changes in cost elements which are external to suppliers, including network costs, wholesale costs, policy costs and other costs. This ensured that the tariff incentivised suppliers to seek efficiencies where they have greatest control over their own costs.

3.71. There are two steps involved in updating the prepayment methodology. First, a weighting is applied to each of the external cost elements (network costs, wholesale costs, policy costs and other costs). Second, each external cost element is updated over time based on an index.

3.72. Some elements of the safeguard tariff are more straightforward to update than others. For example, we think that the approach in the prepayment methodology of updating network costs based on the published charging statements is the most accurate way of reflecting the actual costs paid by suppliers. Likewise, the prepayment methodology updates suppliers' other costs in line with CPI. This simple approach assumes that, once efficient,

suppliers' costs can be expected to change in line with input costs, for which CPI is a reasonable proxy.

- 3.73. However, we recognise that stakeholders may have views on the design of the indices and the weightings applied to update wholesale and policy costs. We discuss these issues in the sections below.

#### *Weighting of indices*

- 3.74. Our current view is that we would largely retain the same index weightings for the prepayment methodology. However, we might consider amending the weightings where this is appropriate and supported by evidence.
- 3.75. For example, one stakeholder told us that the prepayment methodology's assumption that policy costs are the same between single rate and Economy 7 consumers was incorrect, because Economy 7 consumers tend to have higher usage. The stakeholder said this meant that, for Economy 7 consumers, the weight for the policy cost index is too low, and the weight for the wholesale cost index is too high.
- 3.76. We welcome any views on whether there are material issues with the weights used in the prepayment methodology and, if so, how those could be recalculated in a practical and proportionate way.

#### *Indices*

- 3.77. Our current view is that we would largely retain the same indices for the prepayment methodology. However, we might consider amending the design of the indices where this is appropriate, supported by evidence, and measurable using a published external data source.
- 3.78. In principle, we recognise that the choice of wholesale index could affect the wholesale market, as suppliers may seek to purchase wholesale energy in line with the wholesale index used to update the safeguard tariff. Since our proposals will only apply to a portion of the retail customer population, we do not think that there are likely to be any material impacts on the wholesale markets. But there may be other issues, for example, whether the index reflects the costs of buying energy to match the shape of demand over time, known as shaping costs.
- 3.79. Therefore, we are interested to hear your views on whether there are practical refinements we could make to the wholesale index, supported by sufficient evidence to demonstrate that any changes would be proportionate and not add undue complexity.
- 3.80. We will also consider stakeholder views on any refinements to the approach to indexing policy costs. Although the current methodology excludes certain schemes and contains a number of approximations (for example, it uses

forecasts from the Office of Budget Responsibility to index electricity policy costs and CPI to index gas policy costs) it has the advantage of predictability and simplicity. Therefore, we welcome views on any refinements to the approach to the indexation of policy costs, supported by sufficient evidence to demonstrate that any additional complexity would be proportionate.

### **Updating the basket of tariffs approach**

- 3.81. In principle, we would want to update the basket of tariffs drawing on relatively frequent information. This would make the basket more accurate, and would reduce the potential for gaming. One option would be to construct the basket each day, and then to update the level of the cap based on the average basket over a six month period.
- 3.82. However, we recognise that there would be practical issues in very frequent calculations of the basket. For example, we would need to consider how to gather data on every tariff in the market, including those only available directly through suppliers, on a relatively frequent basis. It would also require an ongoing process to check and verify that data. We would need to be able to make accurate judgements about whether certain tariffs should be excluded from the market basket (in line with published criteria) – this would include understanding the nature of increasingly innovative tariff offerings. While straightforward in theory, updating a basket of tariffs could be complex and burdensome in practice.

### **Frequency of safeguard tariff update**

- 3.83. Whichever approach we apply to the benchmark and the methodology for updating it, we will need to consider the frequency of the updates to the safeguard tariff level. At present, this mainly depends on the wholesale index methodology, as this is the component which is most likely to vary within-year. In any event, updating the safeguard tariff level more frequently could expose consumers to more frequent changes in price. Given our initial view on the wholesale index, at this stage we also propose to adopt the six-monthly update frequency used in the prepayment methodology.

### **Administration and compliance with the safeguard tariff**

- 3.84. We recognise that suppliers will need notice of the level of the safeguard tariff before they inform consumers of any changes. The prepayment methodology (which we adopted for the temporary WHD safeguard tariff) requires us to publish the level of the tariff nearly two months before it takes effect.<sup>81</sup> At this

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<sup>81</sup> We have to publish the level of the prepayment safeguard tariff by the fifth working day of February (for a Charge Restriction Period starting in April) or of August (for a Charge Restriction Period starting in October).

current stage, we are not minded to amend this approach for the extended safeguard tariff.

- 3.85. However, in the light of the larger number of customers and suppliers in scope of the extended safeguard tariff, we will be considering changes to our approach to monitoring compliance with the safeguard tariff. It is likely that we will continue to require suppliers to provide us with information around the start of each period to help us monitor compliance. We welcome views on whether the existing compliance approach for the WHD safeguard tariff would be efficient if applied to a larger number of consumers. In particular, we are interested in responses from smaller suppliers as to whether the compliance arrangements would represent a disproportionate burden for their business.

## Appendix A – Consultation Response and Questions

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We want to hear from anyone interested in this document. Send your response to the person or team named at the front of this document. We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can.

**Unless you mark your response confidential, we'll publish it on our website, [www.ofgem.gov.uk](http://www.ofgem.gov.uk), and put it in our library.** You can ask us to keep your response confidential, and we will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

### Chapter 2 – Scope

**Question 1** – What are your views on our preferred approach of identifying consumers for safeguard tariff protection by primarily relying on data-matching?

**Question 2** – What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable consumers?

**Question 3** – Are there other methods for identifying vulnerable consumers that we should consider, either alongside or as an alternative to, our preferred approach?

**Question 4** – What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.

**Question 5** – What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?

### Chapter 3 – Methodology

**Question 6:** Which of our two options for setting the benchmark component of the safeguard tariff would be most effective?

**Question 7:** Do you have any comments on the design issues for either of our two options?



## Appendix B – Analysis of scope options

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### Option 1: Data-matching – Calculating eligible number of consumers

- 1.1. To calculate an estimate for the number of consumers impacted through our data matching exercise, we used a top down approach. We started by calculating the number of individuals on a range of working age or state pension age benefits, which were administered by DWP. These benefits were primarily related to income or disability related needs.
- 1.2. These estimates were based on combination data from DWP, which outlined the number of individuals on different combinations and in singular receipt of different benefits. This was the latest data available to us at the time. This data allowed us to isolate the number of people in receipt of either one, or multiple types of government support. In total, we calculated that there were around 10.8 million people of working or state pension age within our initial target group who received at least one of the benefits outlined below. We did not include the standard state pension.

**Table 1: List of benefits used**<sup>82</sup>

Attendance Allowance	Jobseeker's Allowance
Bereavement Benefit	Pension Credit
Carer's Allowance	Personal Independence Payment
Disability Living Allowance	Severe Disablement Allowance
Employment and Support Allowance	Universal Credit
Housing Benefit	Widow's Benefit
Incapacity Benefit	Income Support

- 1.3. Using estimates from the WHD scheme<sup>83</sup> we approximated the number of individuals who could be successfully matched through any initial data-matching. Data-matching is not 100% successful, and there will always be individuals who cannot be reconciled by suppliers using DWP data.
- 1.4. Our estimations based on previous WHD activity, highlighted that around 8.9 million consumers could be matched successfully, with an initial success rate of around 82%. These 8.9 million consumers would form any initial group that is data-matched. Our analysis of the WHD also showed that with prompting (by sending letters to those unmatched), around 86.5% of data-matching exercises succeeded. This meant that approximately 9.4 million consumers could be

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<sup>82</sup> For benefit explanations see: <https://www.gov.uk/browse/benefits>

<sup>83</sup> Information received from BEIS

successfully matched if additional prompting was undertaken. However for our estimates, we maintained a base level of 8.9 million consumers for whom data-matching could be successful.

- 1.5. Using the proportion of customers on SVT for the large six suppliers (66%),<sup>84</sup> we calculated the number of these matched vulnerable individuals on an SVT. In total, we believe that there are around 5.9 million vulnerable benefit recipients on a SVT.<sup>85</sup>
- 1.6. We then adjusted for there being multiple benefit recipients per household. Our estimate for the number of benefit recipients per household was calculated by averaging the number of claimants of Universal Credit per household claiming Universal Credit (1.05) and the number of individuals in married co-habiting households (1.33).<sup>86</sup> We have assumed there are around 1.19 benefits recipients per household, and therefore around 4.9 million matched vulnerable households on an SVT.
- 1.7. We then had to account for those customers within this estimate who are already covered by the prepayment or WHD safeguard tariff. We estimated the number of customers on the prepayment safeguard tariff and a SVT who would be within this target group, subtracting them from the above estimate. We extrapolated this from the proportion of consumers with a prepayment meter and proxies for low income and benefit receipt, taken from the CMA Energy Market Investigation.<sup>87</sup> We also subtracted the number of consumers covered by our initial WHD safeguard tariff.
- 1.8. We therefore estimate that an additional 2.2 million individual consumers or households can be capped from an extended data matching approach.

### **Option 1: Data-matching – Assumptions and limitations**

- 1.9. We use the latest data on benefits available to us. However, this is likely to change, especially given the recent movement to the Universal Credit system. Our list of benefits does not include those administered by HMRC such as Tax Credits and Child Benefit.

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<sup>84</sup> Supplier customer accounts information April 2017

<sup>85</sup> Extrapolated from DWP benefits data and using the six largest supplier's proportion of SVT customers.

<sup>86</sup> Universal credit data sourced from [Universal Credit Statistics data tables](#) and [Universal Credit Statistics](#). Marital cohabitation statistics sourced from [Population estimates by marital status and living arrangements, England and Wales: 2002 to 2015](#).

<sup>87</sup> Using proportions of PPM customers with income below £18,000 (48%), PPM customers renting from a social landlord (46%) and PPM customers agreeing they financially struggle (44%). See paragraph 9.34 of the [CMA Energy Market Investigation – Final Report](#) and tabs 2257 and 2251 of the [GfK customer survey tables](#).

- 1.10. We assume that vulnerable consumers are more likely to be on a SVT and to have not switched supplier recently, so we use the large six supplier's proportion of consumers on SVT.
- 1.11. We assume that the proportion of unmatched individuals from the WHD data-matching will be similar to running the data-matching process with more benefit groups. This could be an overestimate if the number of consumers served by suppliers who do not offer the WHD disproportionately increases when the number of people being matched is increased. However, if the number of suppliers matched against increase, the success of matching will increase.
- 1.12. We assume the benefit recipients per benefit household to be an average of an upper limit (calculated as the average number of married people per household) and a lower limit (the average number of Universal Credit individuals per Universal Credit household). This could be an overestimate as some benefit schemes (such as housing benefits) are limited to one recipient per household.

## **Option 2: Supplier-led approach – Calculating eligible number of customers**

- 1.13. To understand the number of consumers eligible for the wider vulnerability cap, we have to calculate the number of non-prepayment and non-WHD SVT consumers who are either on a PSR, or in arrears or debt.
- 1.14. We have used a top down approach, and started with the number of customer accounts served by the large and medium suppliers, which covers approximately 97% of the domestic market. We then filtered the data down to the number of non-prepayment customer accounts on SVT.<sup>88</sup> We believe there are around 14 million non-prepayment customer accounts on an SVT.
- 1.15. Using the estimate of consumers capped from the WHD safeguard tariff<sup>89</sup>, which accounted for consumers on WHD already covered by the PPM price cap, we subtracted the number of consumers covered by the WHD safeguard tariff from the number of non-prepayment SVT customer accounts. This gives us a customer account base from which to estimate the number of consumers that could be represented by our proxies for vulnerability, such as the PSR or consumers in debt.<sup>90</sup>
- 1.16. In order to calculate the number of consumers on the PSR we used the proportion of consumers on the PSR from the 2017 Vulnerability Report<sup>91</sup>. As

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<sup>88</sup> Supplier customer account information April 2017 can be found on the [Ofgem data portal](#).

<sup>89</sup> Ofgem (2017) [Financial Protection for vulnerable consumers](#), paragraph 4.27

<sup>90</sup> Consumers in "debt" includes those who are in arrears (consumers who are more than three months late in making a payment but do not yet have a debt repayment arrangement set up) and consumers with a debt repayment arrangement.

<sup>91</sup> Ofgem (2017) [Vulnerable Consumers in the retail energy market: 2017](#), p. 16, Figure 2

the proportions were different between large and medium suppliers, we weighted them based on market share. As we do not have the proportion of consumers on the PSR for non-prepayment SVT consumers, we have to assume that the population proportion applies to the subset.


- 1.17. To calculate the number of consumers in in debt we summed the proportion of consumers in arrears but not repaying a debt and the number of consumers repaying a debt.<sup>92</sup> As the proportions are from the same population and are mutually exclusive, it was okay to sum them. We again assumed that the population proportion applies for the non-prepayment SVT subset.
- 1.18. To calculate the approximate number of additional consumers that could be eligible for safeguard tariff protection by winter 2018-19, taking into consideration those in debt and on the PSR, as outlined above, we took the number of non-prepayment SVT customers minus those covered by the WHD safeguard tariff.
- 1.19. We then applied the proportions mentioned above for PSR and debt and then subtracted the approximate number of consumers falling into these categories. As these groups were not mutually exclusive, this crossover was small. Finally, we calculated that around 2.6 million SVT consumers not yet receiving price protection are either on the PSR or in arrears/debt.
- 1.20. We again made the same assumption above, assuming that the customers in debt is equally distributed over the consumers on PSR and the customers on PSR are equally distributed over those in debt.

## **Option 2: Supplier-led approach – Assumptions and limitations**

- 1.21. As mentioned above, we assume the population proportions for debt and PSR apply to the non-PPM and SVT segment of consumers, as we do not have the data available to calculate the segment-specific proportions.
- 1.22. The proportion for consumers on debt might be an overestimate. We might expect the proportion of people in debt on PPM to be higher (and therefore pull up the average) as it is a method of reclaiming debt.
- 1.23. The proportion of consumers on PSR is likely to be an underestimate as we would expect less engagement from vulnerable consumers who are more likely to be on SVTs.

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<sup>92</sup> Figures have been sourced from [Social Obligations Reporting \(SOR\)](#) data from suppliers



## Providing financial protection to more vulnerable consumers

- 1.24. We have used the latest data available to us, however, we acknowledge that the PSR and debt proportions are for Q4 2016 and the customer accounts are for April 2017.
- 1.25. We calculated the proportion of consumers on PSR using 2016 data, which is before the new PSR definition reform came into place. Since then the eligibility for PSR has become broader and suppliers must take all reasonable steps to identify these consumers. This is likely to mean that the approximation of consumers on PSR is lower than the current data would show.

## Appendix C – Initial views on impact assessment

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- 1.1. This document sets out our current proposed approach to extending financial protections to an updated and more comprehensive definition of vulnerable consumers.
- 1.2. The purpose of this appendix is to support the consultation by setting out the potential impacts of our proposals. At this stage it is a preliminary assessment as our proposals are still developing. It focuses on providing an initial qualitative overview of the potential impacts of our proposals on the main groups affected as well as the potential wider impacts. We will issue a full impact assessment alongside our statutory consultation on our final proposal.
- 1.3. Many of the impacts from our current proposals (referred to below as “Phase Two” in this assessment) are similar to those from the WHD safeguard tariff (referred to below as “Phase One”). We have therefore sought to build on our impact assessment for the WHD safeguard tariff.<sup>93</sup> We have considered impacts relative to a “do nothing” scenario in which our WHD safeguard tariff continues. In either case, our safeguard tariff would be replaced by the government’s market wide price cap when this is introduced.
- 1.4. If you have comments, or suggestions for aspects to include in our future impact assessment, then please feel free to feed in views.

### Methodology

- 1.5. We have put forward views on the impacts of our Phase Two safeguard tariff based around two different methodologies: either applying alterations to the existing prepayment cap methodology, or a basket of cheapest tariffs.<sup>94</sup>
- 1.6. At this stage, it is not possible to say whether these options would lead to a different level of protection. We will identify any differences in our statutory impact assessment when our design work has progressed further.

### Scope

- 1.7. We have also taken into account the different approaches to scope that we are currently considering. These are set out in chapter 2 of this consultation document.

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<sup>93</sup> Ofgem (2017) [Financial protections for vulnerable consumers – technical document](#), chapter five.

<sup>94</sup> See chapter three of this document for details.

## **Impact on consumers**

### **a) Eligible consumers**

- 1.8. We expect our proposals to directly reduce bills for at least 2 million additional households as a result of the expanded eligibility criteria. In addition to our existing (prepayment safeguard tariff) and planned (WHD safeguard tariff from February 2018) protections, our data matching proposal would look to protect around 2.2 million households, while our supplier data option would protect around 2.6 million. Our proposals, in combination with the prepayment and WHD safeguard tariff, will provide protection to around 7 million households.
- 1.9. However these estimates are subject to some uncertainty. For example, the supplier data option could depend on the quality of the internal data sets held by suppliers, such as the depth and accuracy of the suppliers Priority Services Register (PSR). Our estimates are therefore based around a variety of assumptions around customer groups.
- 1.10. The financial benefit that consumers will receive will depend on the level of the safeguard tariff. We will be considering whether it would be appropriate to amend the methodology for setting the safeguard tariff level. As of now, we have therefore not estimated the financial protection (bill reductions) these customers will receive. However, based on our analysis for Phase One, our initial view is that these are likely to be significant for those consumers protected.<sup>95</sup>

### **b) Non-eligible consumers**

- 1.11. We are aware of the risk that suppliers might increase the prices of tariffs available to non-eligible consumers, to compensate for revenues lost as a result of the larger scope of the Phase Two safeguard tariff. However we note that non-eligible consumers will still benefit from the other actions which we are taking to improve competition in the energy market (such as our new database) and will be better placed to shop around for the best deals in the market. We would hope that if suppliers did try to increase prices in this segment of the market, they would lose customers as a result.

### **c) Impact on engagement**

- 1.12. It is too early to say whether our proposed Phase Two measure will have a significant impact on consumer engagement. The number of consumers in scope for Phase Two will be larger than for Phase One. However, we may also refine the methodology for the Phase Two safeguard tariff. Any refinements we make could affect the potential financial gains consumers are able to obtain by

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<sup>95</sup> Ofgem (2017) [Financial protections for vulnerable consumers - technical document](#), Chapter 5.

switching to a new tariff and/or supplier, by increasing or decreasing the difference between the safeguard tariff and the cheapest deals in the market.

1.13. We also note that vulnerable consumers have a lower than average propensity to engage.<sup>96</sup> Where consumers already have a low propensity to engage, reducing the gains from switching through a safeguard tariff may have a more limited incremental impact on their likelihood of engaging. Given this uncertainty, we will consider consumer engagement further once we have a defined scope for Phase Two.

1.14. In response to our statutory consultation on Phase One, several suppliers noted that they had observed reductions in switching in their prepayment market segments since the implementation of the prepayment safeguard tariff. We will consider any evidence as part of our impact assessment, and welcome any further information that stakeholders can provide on the impacts of the prepayment safeguard tariff.

### **Impact on suppliers**

#### **a) Impact on supplier revenues**

1.15. Phase Two will lead to a direct reduction in supplier revenues. The impact on individual suppliers will depend on a number of factors, including the proportion of eligible customers which are already protected by Phase One or are currently on a fixed-term tariff. At this stage we have not quantitatively assessed the impact of Phase Two on supplier revenues, although we expect this to comprise a relatively small part of the total revenue of these suppliers.

#### **b) Impact on supplier pricing**

1.16. As outlined above, and within our Phase One impact assessment, there is a risk that suppliers increase prices for non-eligible customers. We are also aware that there has been a convergence of prepayment tariff prices for prepayment customers, which coincides with the introduction of the prepayment safeguard tariff.

1.17. If we were to use a market basket, this could affect suppliers' pricing by incentivising them to alter the price of any tariffs included in the basket. However we would look to use a basket with tariff values from a sufficient number of suppliers to limit the influence any individual supplier could have on this mechanism.

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<sup>96</sup> Ofgem (2017) [Financial protections for vulnerable consumers - technical document](#), Chapter 2.



### **c) Impact on supplier behaviour**

- 1.18. Within our Phase One impact assessment, we assessed the impacts of our proposals on supplier behaviour. Similar risks and mitigations may apply for Phase Two.
- 1.19. Depending on the scope used for Phase Two, we are also aware of the risk that suppliers look to decrease the number of consumers on measures such as the Priority Services Register. We will consider any scope-specific impacts further when deciding which approach to take, but as an initial point we note that the broad and enforceable vulnerability principle in the domestic Standards of Conduct makes it clear that suppliers have a special responsibility to treat vulnerable consumers fairly. In addition, the risk of suppliers seeking to avoid vulnerable consumers can be mitigated through setting the level of the safeguard tariff appropriately.

### **d) Impact on supplier administration costs**

- 1.20. We are aware that extending protection to more vulnerable consumers could lead to increases in supplier administration costs. For instance, we expect that suppliers could incur new identification costs from data matching exercises for Phase Two which would not be covered by the current WHD scheme, such as staff costs for running additional data-matching exercises and handling more queries from consumers.
- 1.21. At this stage, we believe that using supplier-led data identification would have more marginal impacts on identification costs, as suppliers would be using their own internally held flags to identify eligible customers.
- 1.22. We recognise the importance of considering the costs to suppliers, but as this stage lack the available data to assess to direct impact our proposals could have on supplier costs. We are interested in any evidence from suppliers on the costs of identifying new and larger vulnerable consumer groups through a new data-matching exercise, and any evidence of costs involved with using information suppliers already hold. However, under either approach, we currently think it is plausible that identification and other administrative costs might only make up a small proportion of the benefits which our proposals could provide to eligible vulnerable consumers.

## **Wider impacts**

### **a) Impact on investor perception**

- 1.23. Within our Phase One assessment, we considered the possibility that the safeguard tariff could have a negative impact on investor perception of domestic energy suppliers, resulting in an increase in their cost of capital. Phase Two would cover more consumers than Phase One, but we do not consider that there would be a significant difference in this area. We also note that we may be able to refine the methodology used to set the level of the safeguard tariff so that it meets our aims.

**b) Impact on market structure**

- 1.24. Unlike Phase One, our Phase Two proposals could apply to smaller suppliers. Expanding the scope to small suppliers is also likely to mean including a greater diversity of business models in scope. However, we welcome any evidence that illustrates whether such costs could be disproportionate for small suppliers, and if necessary, how we could mitigate this.
- 1.25. At the extreme, a supplier might consider exiting the market if it was consistently unable to cover its costs. Our objective for the methodology is to apply a benchmark which reflects efficient costs and to allow efficient companies to compete, which should reduce this risk. Even if exit did occur in this scenario, the harm to consumers might be limited, given that this would represent an inefficient supplier leaving the market.
- 1.26. However, it appears plausible that a small supplier focussed on vulnerable consumers may be less able to withstand short-term differences between the safeguard tariff and its actual costs (eg a spike in short-term wholesale costs which was not reflected in the wholesale indices). We may be able to address some of these risks through refinements to the Phase Two methodology. We welcome any evidence from small suppliers with large numbers of vulnerable consumers on default tariff arrangements about any specific risks that they may face.

**c) Impact on government, government policy and Ofgem**

- 1.27. As discussed in our Phase One impact assessment, there will be consequential impacts on VAT receipts if bills fall. This will depend on the level of the Phase Two safeguard tariff.
- 1.28. Ofgem would incur some costs from developing, implementing and monitoring a Phase Two safeguard tariff. We have not estimated these costs but do foresee these as manageable.
- 1.29. Under a data-matching approach, there could also be some costs of running the data-matching process. We will consider this further in our impact assessment for Phase Two.

**d) Impact on third parties (eg price comparison websites)**

- 1.30. As with Phase One, our proposals could reduce the savings available from switching for eligible vulnerable customers. This could lead to fewer eligible vulnerable consumers looking to change supplier, and so a reduction in the commission earned by price comparison websites (PCWs) and collective switching providers. We note that if eligible Phase Two consumers are less likely than average to switch, they may therefore also be less likely to use a PCW. We could assume that these consumers make up only a small proportion of a third party intermediaries' business, but are interested in any views held by PCWs on this possible issue.

**e) Other wider impacts**

1.31. If we adopted the prepayment methodology, this may lead to the level of the safeguard tariff diverging from the intended level (reflecting efficient costs) over time. This could lead to the safeguard tariff becoming either too high (delivering insufficient protection) or too low (risk supplier finance ability and their treatment of customers). While headroom could address the latter point to some extent, it may not be sufficient over a longer period.

**Monitoring and evaluation**

1.32. At this stage, it is uncertain how long the vulnerable consumer safeguard tariff might be in place. Phase Two could provide more enduring protection, but our approach will depend on the government's legislation and our work to implement the market-wide price cap. We intend to consider the approach to monitoring and evaluation as our proposals develop further.

1.33. However, we expect to monitor the direct financial impacts on consumers by monitoring the difference between the amount that consumers will pay under the safeguard tariff and the amount they would have paid otherwise. In terms of monitoring compliance, we will consider what compliance checks would be required to ensure that suppliers are applying the safeguard tariff to the right consumers. Our approach could be similar to what is used for our other safeguard tariffs.

1.34. Due to the larger number of consumers covered by a Phase Two proposal, we could monitor the impact on consumer engagement as well as any other unintended impacts on suppliers and will consider this as our work progresses.

## Appendix D – Description of the prepayment methodology

- 1.1. The prepayment safeguard tariff came into force on 1 April 2017. Although the licence condition was introduced by the CMA, we have responsibility for updating the level of the prepayment safeguard tariff. This is based on a methodology specified in the licence condition.
- 1.2. The prepayment safeguard tariff applies to all customers with prepayment meters, except those with fully interoperable smart meters. The prepayment safeguard tariff applies to all tariffs, whether these are fixed or variable.
- 1.3. The prepayment methodology sets the prepayment safeguard tariff at different levels for gas, standard electricity and Economy 7 electricity customers in each of the 14 electricity network charging regions (a total of 42 safeguard tariff levels for each period). The safeguard tariff defines a maximum amount that can be charged to prepayment customers for any given level of consumption.
- 1.4. The level of the safeguard tariff is updated every six months, on 1 April and 1 October. We publish the revised levels of the safeguard tariff approximately two months in advance. Table 2 shows the breakdown of the prepayment safeguard tariff that applies for the period 1 October 2017 to 31 March 2018.

**Table 2: Breakdown of the prepayment safeguard tariff, 1 October 2017 – 31 March 2018<sup>97,98,99</sup>**

	Electricity (single rate)	Gas	Electricity (economy 7)	Dual fuel (with single rate electricity)
Competitive benchmark	£327.86	£304.41	£380.19	£632.27
Payment method cost uplift	£24.74	£40.21	£24.74	£64.95
Headroom	£14.92	£11.99	£13.81	£26.91
Network allowance (GB average)	£135.58	£122.46	£141.86	£258.05
Safeguard tariff (excluding VAT)	£503.10	£479.07	£560.59	£982.17
<b>Safeguard tariff (including VAT)</b>	<b>£528.26</b>	<b>£503.02</b>	<b>£588.62</b>	<b>£1,031.28</b>

Source: Ofgem calculations

<sup>97</sup> A separate safeguard tariff is not published for dual fuel – the values in the final column are derived by summing the values for electricity (single rate) and gas.

<sup>98</sup> Level of the safeguard tariff is expressed for current medium Typical Domestic Consumption Values (TDCVs). These are: 3,100kWh for single-rate electricity, 4,200kWh for Economy 7 electricity, and 12,000kWh for gas. We recently amended the TDCVs with effect from 1 October 2017 – these are the latest values.

<sup>99</sup> Network component is a simple average across the 14 electricity distribution regions.

### **Benchmark, payment method uplift and network charges**

- 1.5. The competitive benchmark for the prepayment methodology is based on the average direct debit price of two mid-tier suppliers in 2015. The CMA collected information to estimate the average prices of these suppliers.
- 1.6. The CMA made a number of adjustments to the average prices of these two suppliers, to ensure the benchmark was comparable to the prices of other suppliers, including larger suppliers. These comprised adjustments to allow for:
  - the difference in the costs these suppliers incurred in relation to social and environmental programs as a result of their smaller size
  - a standardised approach to the amortisation of customer acquisition costs
  - the level of overhead costs that would be expected for a company that was neither growing nor shrinking
  - removing the network cost element, to account for cost differences due to regional distribution of customers
  - a return (i.e. an average EBIT margin) of 1.25%.
- 1.7. The prepayment methodology includes separate benchmarks for a gas consumer, a single rate electricity consumer and an Economy 7 electricity consumer.
- 1.8. The benchmark at nil consumption was set differently: the CMA defined the level of the price cap at nil consumption to be equal to the average standing charge of the Six Large Energy Firms' prepayment tariffs as at 30 June 2015, weighted by customer numbers.
- 1.9. The benchmark was not specific to prepayment customers. The analysis was carried out for a gas or electricity consumer paying by direct debit, and the competitive benchmark was then uplifted to allow for the additional costs the CMA estimated a supplier would incur in serving a prepayment customer. Table 3 sets out the values of these cost uplifts – and those for a customer paying by standard credit.<sup>100</sup>

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<sup>100</sup> Full details of the CMA's estimates are provided in: CMA (2016) [Energy market investigation – final report, appendix 9.8](#)

**Table 3: CMA estimates of payment method cost differentials**

	Premium to direct debit	
	Range	Central estimate
<b>Prepayment</b>		
- Electricity	£19-£33	£24
- Gas	£31-£48	£39
- Dual fuel	£50-£81	£63
<b>Standard credit</b>		
- Electricity	£39-£69	£47
- Gas	£45-£81	£53
- Dual fuel	£84-£150	£100

Source: Information from appendix 9.8 to the CMA's final report

1.10. The CMA's benchmarks exclude costs resulting from network charges. This reflects that these costs will depend heavily on a supplier's mix of customers (with charges varying by region and meter type). This component of prices was estimated by combining published network charges with assumptions around consumption, load factors and other variables which influence the amount a supplier is charged.

### Headroom

1.11. The prepayment methodology includes a headroom level of 4.23% for electricity and 3.48% for gas, fixed across all suppliers. This percentage is applied to all elements of costs except the network allowance. It therefore scales with consumption, and will vary over time according to movements in the cost indices. The percentages were intended to deliver around a £30 headroom for a dual fuel prepayment consumer with typical consumption.

1.12. In setting this level of headroom the CMA took into account the impacts on customers and suppliers, through: the reduction in detriment for prepayment consumers, the impact on profitability for suppliers, and the effect on competition.<sup>101</sup>

1.13. The chosen level of headroom was expected to result in around two-thirds of prepayment customer detriment being reduced for customers with each fuel/meter combination, and a greater proportion of detriment being reduced in some cases.<sup>102</sup> At most, almost 100% of the detriment was expected to be addressed for single fuel gas customers with single rate meters.<sup>103</sup> The chosen level of headroom was expected to generate an average saving of £71 per customer.<sup>104</sup>

<sup>101</sup> CMA (2016), [Energy market investigation – final report](#), paragraph 14.251

<sup>102</sup> CMA (2016), [Energy market investigation – final report](#), paragraph 14.258 and table 14.13

<sup>103</sup> CMA (2016), [Energy market investigation – final report](#), paragraph 14.259

<sup>104</sup> CMA (2016), [Energy market investigation – final report](#), paragraph 14.261

1.14. For a hypothetical supplier, a zero headroom level under the prepayment methodology would have covered efficient costs and allowed for a 1.25% EBIT margin for the supplier's single fuel prepayment tariffs. Including headroom increased the weighted average EBIT margin across all tariff types to around 4% at medium TDCV (for an efficient supplier). This margin was in line with the large suppliers' views on a reasonable competitive margin for retail supply.<sup>105</sup>

### Updating the safeguard tariff

1.15. Under the prepayment methodology, we update the level of the prepayment safeguard tariff twice a year. The two periods run from 1 April to 30 September and from 1 October to 31 March. We publish the levels of the safeguard tariff around two months before the start of each period.

1.16. The level of the prepayment safeguard tariff is set according to developments in a series of cost indices. Different indices are used to approximate trends in different components of the safeguard tariff – these are set out in tables 4 and 5 below.

1.17. In order to apply weights to various indices when updating the competitive benchmark (which covers wholesale, policy and other costs), the prepayment methodology includes an assumption about the proportion of the competitive benchmark which was made up of each cost category.<sup>106</sup>

**Table 4: Indices used to update level of prepayment safeguard tariff – electricity (single rate)**

Element		Indexed using
Competitive benchmark	Wholesale costs	Prices of winter / summer forward contracts covering the Charge Restriction Period, and the subsequent season
	Policy costs	Office for Budget Responsibility forecasts of environmental levies for financial year
	Other	Consumer Price Index (inflation)
Payment method cost uplift (prepayment)		Consumer Price Index (inflation)
Network cost / balancing services component		Charges published by National Grid and electricity distribution network operators

<sup>105</sup> CMA (2016), [Energy market investigation – final report](#), paragraph 14.269

<sup>106</sup> CMA (2016), [Energy market investigation – final report](#), table 14.4

**Table 5: Indices used to update level of prepayment safeguard tariff – gas**

<b>Element</b>		<b>Indexed using</b>
Competitive benchmark	Wholesale costs	Prices of quarterly forward contracts covering the Charge Restriction Period, and the subsequent two quarters
	Policy costs	Consumer Price Index (inflation)
	Other	Consumer Price Index (inflation)
Payment method cost uplift (prepayment)		Consumer Price Index (inflation)
Network cost / balancing services component		Charges published by National Grid and gas distribution companies



## Appendix E - Feedback on this consultation

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We believe that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about how we've conducted this consultation. We are also keen to get your answers to the following:

1. Do you have any comments about the overall process adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand? Or could it have been better written?
4. Were the report's conclusions balanced?
5. Did the report make reasoned recommendations for improvement?
6. Do you have any further comments?

Please send your comments to: **[stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk)**