

# Eliminating the poverty premium in energy

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## EXECUTIVE SUMMARY

### Purpose and approach

This report examines the ‘poverty premium’ in energy – a phenomenon where those living below the poverty line pay more when they buy their gas and electricity than higher-income households. We define the “poverty premium” in energy as: “the extra cost that households on low incomes incur when purchasing the same energy services as households on higher incomes”.

The report draws on fieldwork with low-income consumers as well as analysis of the prevalence and costs of the premiums, and five policy events held across England and Scotland.

### The cost of the poverty premium and how it is experienced

Chapter 2 explains how consumers experience the premium and the additional costs that result. Evidence indicates that the average additional costs for individuals that experience the relevant premiums are:

- Not being on the best energy tariff: £308 premium.
- Using a pre-payment meter: £80.
- Paying to receive paper bills: £10.
- Not paying by direct debit: £76
- Being on a tariff that is unsuited to the consumer’s consumption patterns (Unknown)
- Not having access to cheaper forms of energy (Unknown)

Low-income consumers consider these additional costs to be iniquitous and unfair.

### The factors underlying the poverty premium

Chapter 3 describes the underlying factors that cause the poverty premium in energy to arise. Many of these factors are a function of living on a low income – for instance, consumers often prefer to pay their bills in ways other than direct debit because these alternative methods allow them to exert greater control on their limited budgets. Low-income consumers are less likely to have switched to the best deals for a wide range of reasons, including more limited access to banking and internet products, lower levels of digital literacy and greater risk aversion (because, for example, the impact of bill overlaps is greater on those on a low income).

Business practices and the costs of servicing low-income consumers also play a part. Cost-reflective premiums – for instance the additional costs of servicing consumers on pre-payment meters – though smaller than they were, still exist. Low-income consumers subsidise higher-income consumers because energy suppliers can identify consumers who are less responsive to price signals and more likely to stick with their supplier, and can thus offer them more expensive deals knowing that they are very unlikely to switch to

an alternative supplier. Suppliers can then reserve the better-deal products for consumers who seek out the best deals, who tend to be more affluent.

## Policy responses

The report puts forward policies to reduce and eliminate the energy poverty premium. These are based on the SMF's own analysis and informed by insights from a wide range of stakeholders engaged through the research.

### Reforming the Warm Home Discount

The Warm Home Discount (WHD) provides a subsidy of £140 to households at risk of fuel poverty. However, it is poorly designed and targeted.

- *Recommendation: The criteria for eligibility for the WHD should be standardised and cover low-income households.*
- *Recommendation: The rebate should be made available from all suppliers. If necessary, the Government should reimburse smaller suppliers for the costs of the WHD where they incur these costs.*
- *Recommendation: Eligible consumers should be identified through the sharing of data for instance on entitlement to means-tested benefits, and consumers should be made eligible automatically.*

### State energy suppliers

There are a growing number of energy suppliers being set up and run by councils, city government and indeed proposed by the Scottish Government. The report argues that the principal benefits lie in promoting trust and engagement among low-income consumers, as well as addressing specific local challenges.

- *Recommendation: The introduction of new state suppliers should be informed by behavioural experiments and analysis of current experience as to whether low-income consumers are more likely to switch if a public-sector supplier is in the market.*
- *Recommendation: New state suppliers should seek to address specific local problems. For instance, in London, payment methods appear to be a challenge.*
- *Recommendation: There is a risk that government suppliers may undermine trust if they over-promise on what they can deliver. It is very unlikely that they will always be able to offer the lowest price. Therefore, the purpose and marketing message behind any social supplier should be clear.*

### Energy bill price cap

The report puts forward a series of recommendations to help ensure that the energy price cap helps address the energy poverty premium.

- *Recommendation: The Government's proposal in its draft bill to include all consumers on SVTs should be pursued thus ensuring that all low-income consumers are included. If the WHD can be reformed as above then this could be an effective way of targeting the cap in the future.*

- *Recommendation: The price cap should be set on an absolute basis because this is likely to contribute to greater simplicity and trust in the market, whilst ensuring that all consumers are protected. It should include headroom for competition.*
- *Recommendation: The cap should be time-limited. However, it should only be removed if it can be demonstrated that low-income consumers have an alternative method for getting a good deal in the market.*
- *Recommendation: The regulator should remain alert to the risk that suppliers may respond to the cap by withdrawing products that suit consumers with low usage patterns as has been in the case in the PPM market.*

### **Auto-switch scheme**

There is little prospect of a policy being developed that can encourage a large share of low-income consumers to switch their energy tariff regularly. The energy price cap is likely to further reduce the motivation for such consumers to switch.

- *Recommendation: The Government should trial an opt-out auto-switch policy with a view to introducing a nation-wide scheme so that consumers have an alternative means of protection from rip-off tariffs when the price cap is lifted at the beginning of the next decade. Energy suppliers would bid to provide the best deal to consumers who participated. The report puts forward recommendations to ensure that auctions are designed so that low-income consumers participate and receive a deal that matches their consumption needs.*

### **Smart meters**

There is a risk that low income consumers may be more resistant to smart meter technology than more affluent households. The latest survey by Smart Energy UK found that, with the exception of those aged over 55, low-income consumers were the group that reported the least likelihood to request a smart meter or accept an offer of installation in the next six months (42%).

- *Recommendation: The Government should ensure that smart meters continue to be taken up equally among low-income consumers as among the wider population. If necessary this will have to involve strict requirements that SMs are installed in a cross-section of households rather than just offered.*

### **Paper billing**

Charging for paper billing acts as an incentive to switch to digital communications, but it is unclear whether the charge acts as an incentive for most consumers who remain on paper-based billing.

- *Recommendation: Ofgem should test whether the financial incentive for consumers to opt for digital billing is effective. In the long-term, Ofgem should look to spread the costs of paper billing across all consumers.*

## **The costs of being on a pre-payment meter**

The costs of servicing consumers on a pre-payment meter (PPM) have fallen markedly over time and should fall further with the arrival of smart meters and other technology.

- *Recommendation: The regulator should move in the medium-term to mandate suppliers to offer the same deals to PPM consumers as they do to other consumers. This would force suppliers to innovate and to work with social enterprises and technology companies to reduce the remaining costs associated with PPMs. To this end, Ofgem could set a target date for such a policy, e.g. 2023.*

## CHAPTER 1: INTRODUCTION

### Context

This report examines the concept of the ‘poverty premium’ in energy – a phenomenon where those living below the poverty line pay more when they buy their gas and electricity than higher-income households.

In recent years there has been growing discussion around the “fairness” of consumer markets in the UK, and the Conservative Government has committed to publishing a Green Paper on the topic in 2018.

The market debated most is energy. Households spend significant proportions of their disposable income on gas and electricity, it is a basic need, and there is evidence that many households are receiving a poor deal. The Conservative Government is now taking forward legislation to cap energy prices, whilst the Labour Party is committed to re-nationalising the energy companies if it returns to power. This agenda is important not only in Westminster but also in the devolved administrations. The Scottish Government’s draft Energy Strategy refers to its priority ‘to ensure the market works for all consumers, and particularly those vulnerable to fuel poverty’ and ‘fair outcomes for those on low incomes’.<sup>1</sup>

In 2015/16, there were approximately 14 million individuals living below the poverty line in the UK.<sup>2</sup> Households on relatively low incomes can be particularly susceptible to receiving a bad deal in energy.<sup>3</sup> Given their low-income status, paying a premium may have a disproportionately detrimental impact on their lives. This is particularly so given the fact that they spend a much higher proportion of their disposable income on energy than more affluent households. One consequence for the poorest households is that they under-heat their properties, harming health and well-being.<sup>4</sup> This related phenomenon of fuel poverty affects 11% of households in England (2015), 31% in Scotland (2015), 23% in Wales (2015) and 42% of households in Northern Ireland (2011).<sup>5</sup>

This report describes the problem of the poverty premium in energy, how it arises and what factors underlie it. It then goes on to propose policy interventions that could help reduce and eliminate the phenomenon. This report was commissioned by JRF as part of its commitment, and that of its partners in the Fair by Design project, to help eliminate the poverty premium by 2027.<sup>6</sup>

### Research methods

The research draws on:

- A review of UK-based and international literature.
- Depth interviews with 20 low-income consumers in London and Birmingham.
- A focus group with low-income consumers in London.
- Three roundtable events held in London, Manchester and Edinburgh focusing on the energy poverty premium and one event in London on financial services.

- Discussions with experts and other stakeholders.

For further detail on the research methods please see Appendix 2.

### Report structure

The structure of this report is as follows:

- Chapter 2 defines the poverty premium in energy and how it is experienced.
- Chapter 3 explains the factors underlying the poverty premium in energy.
- Chapter 4 describes the potential range of responses.
- Chapter 5 sets out a shortlist of policy reforms.

## CHAPTER 2: WHAT IS THE POVERTY PREMIUM IN ENERGY?

This chapter defines the “poverty premium” in energy, and explains how it is experienced

### What do we mean by the “poverty premium” in energy?

We define the “poverty premium” in energy as: “the extra cost that households on low incomes incur when purchasing the same energy services as households on higher incomes”.<sup>7</sup>

The notion of a poverty premium was coined in 1967 in *The Poor Pay More*, a book by US sociologist David Caplovitz. It considered, for example, how instalment plans lead to lower-income households paying more for big ticket items such as televisions and kitchen appliances. In the UK, Save the Children and the University of Bristol have calculated estimates of the prevalence and cost of the premium.<sup>8</sup>

We emphasise the point about “the same” goods and services; the poverty premium is focused on the notion that individuals on lower incomes pay more for identical energy services than someone on a higher income. That is, we are adjusting for differences in quantity and quality and comparing on a like-for-like basis – we are interested in the *per unit* cost that individuals face when purchasing electricity or gas.

We do not infer a minimum level of reasonable consumption. The latter methodology is used to determine ‘Fuel Poverty’. By exclusion, we are not implying that fuel poverty is unimportant, merely that it is a different phenomenon that requires different policy responses (see Box 1 for more detail).

By “low-income” household, we mean households that are in relative poverty. The official definition of poverty refers to households that have below 60% of median equivalised household disposable income (before or after housing costs).

#### **Box 1: The ‘poverty premium’ and ‘fuel poverty’**

‘Fuel poverty’ is a well-established policy concern. It relates to an adequate level of heating that all households should be able to afford. Each of the nations in the UK defines fuel poverty slightly differently. According to Ofgem:<sup>9</sup>

- In England, a household is said to be fuel poor if it has above-average energy needs, and if it were to spend the amount needed to fully meet its energy needs, it would be left with income below the official poverty line.
- In Northern Ireland, Scotland and Wales, fuel poverty is defined as households which would have to spend 10% of their income to achieve adequate standards of warmth (although their calculating methods differ).

Fuel poverty has received widespread attention from policymakers both in Westminster and in the devolved nations. This has influenced schemes such as the Decent Homes programme, subsidies that go to lower income and other vulnerable households, and the Energy Company Obligation.

## How does the poverty premium manifest itself in energy?

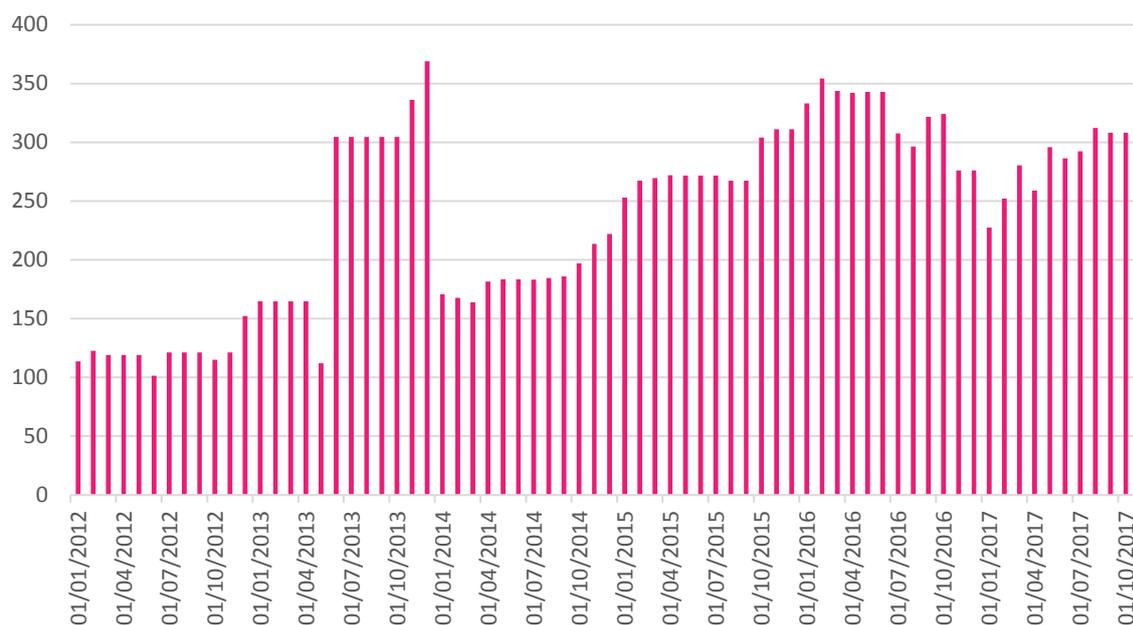
The poverty premium in energy manifests itself in multiple ways. Consumers can experience more than one premium simultaneously. These mechanisms comprise imposed premiums (where the market offers zero choice), such as indebted consumers being put onto a prepayment meter by their supplier; and ‘choice-driven’ premiums (where consumers at least theoretically have a choice even if, for a range of reasons, they are poorly-placed or unable to benefit), such as being on an expensive energy tariff.<sup>10</sup>

### Not being on the best energy tariff

Low-income consumers may pay a premium if they are not on the best tariff. In energy, this is manifested most frequently when consumers pay more to be on a default ‘Standard Variable Tariff’ (SVT) than they do if they are on a fixed term tariff (FTT). The penalty for being on a worse tariff has varied over time, but being on a SVT with a Big Six supplier rather than the cheapest deal in the market has typically costed between £200 and £350 more per year since 2015. We do not include here consumers paying more for a green tariff as the product is qualitatively different (i.e. they are paying to receive ‘greener’ energy).

Data from Ofgem shows that the price difference between the average SVT from the six largest suppliers and the cheapest tariff in the market was £308 at the end of November 2017.<sup>11</sup> Figure 1 demonstrates that the differential has remained very large since mid-2013.

**Figure 1: Difference in £s between ‘Average SVT (largest six suppliers)’ and ‘Cheapest tariff (all suppliers)’**

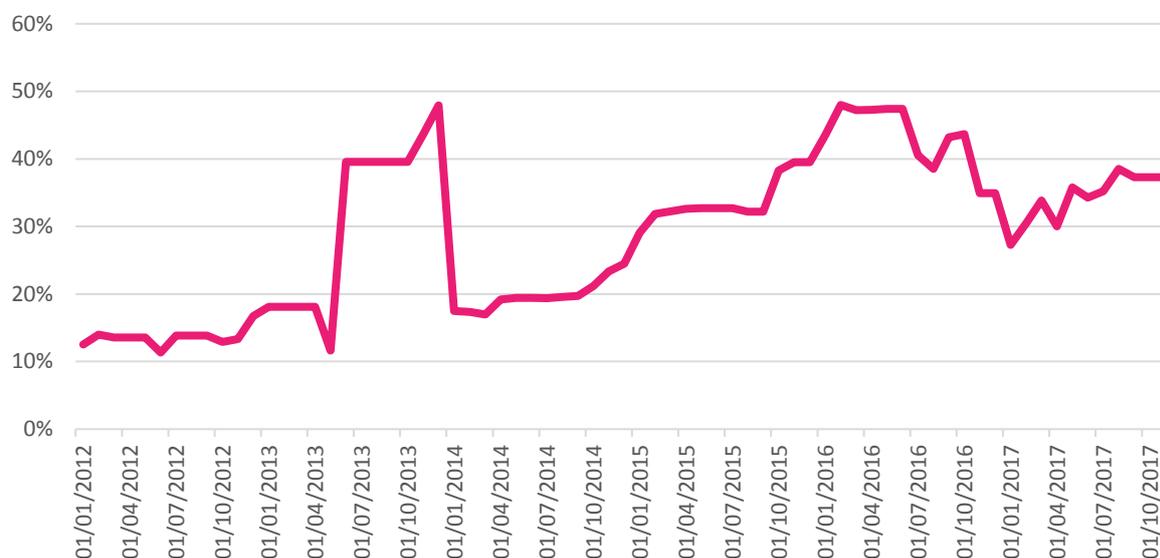


Source: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>. Calculated as Difference between ‘Average SVT (largest six suppliers)’ and ‘Cheapest tariff (all suppliers)’

While Figure 1 reveals that the premium is large in absolute terms, Figure 2 shows that it is also very significant as a proportion of the cheapest tariff. At the same time as energy bills have risen in recent years, the proportional difference between the default and best deals has also grown. In 2012, those on SVTs paid around 12% more. They now pay 38% more. It might be noted that these premiums for the highest tariffs are relative to the complete cost of the bill, which includes exogenous costs which the suppliers cannot

control – such as green levies and distribution costs.<sup>12</sup> If these were stripped out then the premium as a proportion of the cost of the lowest tariff would be much higher still.<sup>13</sup>

**Figure 2: Percentage difference between 'Average SVT (largest six suppliers)' and 'Cheapest tariff (all suppliers)'**



Source: SMF analysis of Ofgem data. <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>.

In late 2017, Ofgem estimated that 64% of accounts with the Big Six were on a SVT.<sup>14</sup> Those on lower incomes are less likely to have switched their provider and more likely to be on a SVT. A survey carried out by the CMA found that – among other characteristics – non-switchers were more likely to be on lower-incomes; the same was true of consumers who reported a low likelihood of switching in the future.<sup>15</sup> This results in a situation where those on lower incomes end up, on average, paying a higher cost per unit of electricity or gas. Survey research by the CMA found that only 20% of households with incomes below £18,000 switched suppliers in the period 2013 to 2015. This compared with 35% for households with incomes above £36,000.<sup>16</sup> Meanwhile, 39% of customers living in households earning less than £16,000 have never switched supplier, versus 29% of those in households earning above £16,000.<sup>17</sup>

Figure 1 illustrates the size of the potential additional cost for consumers who do not switch and who have not been protected by the energy price cap. As of March 2018, consumers who receive the Warm Home Discount or who are on a prepayment meter have their prices per unit of energy capped.<sup>18</sup>

### **Being on a tariff whose charge structure does not match your energy consumption**

Low-income consumers may pay a premium if the charging structure of the tariff is sub-optimal for their usage patterns. Low-income consumers are more likely to have lower consumption patterns, whilst most products on the market (including SVTs) have standing charges that suit households that use more energy.<sup>19</sup>

Analysis by the Centre for Sustainable Energy at the beginning of this decade found that only 28% of low income households consumed more than the mean level of gas and electricity. This compares to 63% of households in the top income quintile.<sup>20</sup>

### **Being on a pre-payment meter**

A pre-payment meter (PPM) is a meter installed in a home which requires the consumer to pay upfront for their energy rather than in arrears. Consumers have historically paid more for being on a pre-payment meter than for being on standard billing and payment terms. Consumers face charges for the installation and removal of meters. The tariffs are higher than those offered to consumers paying by direct debit. There are also fewer tariff choices available for PPM consumers. The CMA calculated the premium paid by PPM for this method of payment as £75 to £80 per year.<sup>21</sup>

As will be discussed later, some consumers derive value from having a PPM, in terms of control over budgeting. As such, energy via a PPM may not be “identical” to energy paid for by direct debit. However, we note that Ofgem has reported that more than 60% of PPMs were installed due to debt; in other words, the majority of PPMs are imposed on consumers.<sup>22</sup>

Those on lower incomes are more likely than more affluent consumers to be on PPMs, because they are more likely to move into homes where there are existing PPMs; because they are more likely to have been put onto a PPM as a result of arrears on their bill or poor credit history; and, because they are more likely to attach value to pay-as-you-go. Around 13% of consumers in Great Britain use a PPM for gas.<sup>23</sup> Of these consumers, 21% are in fuel poverty compared to 7% of those who use Direct Debit.<sup>24</sup>

### **Not paying by direct debit**

Even among consumers not on a PPM there is significant variation in the costs of payment. Paying bills on receipt either monthly or quarterly by cheque or BACS payment is often more expensive than monthly direct debit. As discussed below this derives from structural and behavioural factors such as control over budgeting, access to suitable banking products and digital inclusion. The University of Bristol calculated that paying on receipt of a bill costs a dual fuel customer £76 above that of direct debit consumers.<sup>25</sup>

### **Using paper rather than electronic billing**

Energy companies often charge consumers more for paper billing than for electronic billing. This can generate an additional poverty premium in energy given that digital exclusion is more prominent among those on lower incomes. The costs of this premium are more marginal, and are estimated at around £10 per year for a dual fuel customer.<sup>26</sup>

### **Not having access to cheaper forms of energy**

In some regions, lower income households are more likely to live in areas which do not have access to the gas network, leaving such households reliant on more expensive forms of heating such as oil and electricity.<sup>27</sup> In 2014, approximately 15% of households in England that were not connected to the gas grid were classed as fuel poor, compared to 10% of households that were connected to the gas grid.<sup>28</sup> This problem is particularly severe in Scotland. Ofgem research has shown that occupants of electrically-heated homes are more likely to be on low incomes.<sup>29</sup> It is debatable whether this is part of the energy poverty premium as the consumer may be paying the same as other consumers for their electricity per unit.

## Interactions between different premiums

It is important to note that premiums may interact, and experiencing one premium may make it more (or less) likely that a consumer also experiences another one. For instance:

- PPM consumers are more likely to be on expensive SVT tariffs because (at least in part) there are fewer products to choose from in this part of the market. In September 2017, only 6% of PPM gas consumers were on a fixed contract compared to 20% for those paying by credit and 52% of those paying by direct debit.<sup>30</sup>
- PPM consumers are not exposed to the additional costs of paying by quarterly bills (because they are already charged a premium to pay via their PPM).

## The prevalence and impact of the poverty premium in energy

Table 1 below gives an indication of the scale and prevalence of the different components of the poverty premium in energy. In all cases it assumes a dual fuel consumer. The final column provides the application of a new method of calculating the poverty premium developed by the SMF. This multiplies the £ size of the cost by the difference in the prevalence of the premium between low-income and higher-income consumer groups. This method is expanded in a separate SMF research paper.<sup>31</sup>

**Table 1 Prevalence and scale of poverty premiums in energy**

Type of poverty premium	Average cost for those who experience the premium	Proportion of low-income consumers affected <sup>32</sup>	Proportion of high-income consumers affected	SMF method weighted cost
Not being on the best energy tariff	£308	73% <sup>33</sup>	65% <sup>34</sup>	£25
Tariff structure	Unknown	8 in 10 of the poorest decile of households consume below the average	Unknown	Unknown
Using pre-payment meters	£80	30% <sup>35</sup>	13% <sup>36</sup>	£14
Paying to receive paper bills	£10	25% <sup>37</sup>	Unknown	n/a
Not paying by cheapest billing method	£76	7% to 10% <sup>38</sup>	7% <sup>39</sup>	£2
Not having access to cheaper forms of energy	Unknown	Unknown	Unknown	Unknown

## Proportional impact of the poverty premium

It is also important to note that low-income consumers spend a higher share of their income on energy compared to more affluent households. Therefore, the effect of the energy poverty premium is more severe than its absolute amount implies. Ofgem has found that rising prices, consumption patterns and tariff structures meant 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 income in 2005. In contrast, the proportion spent by the highest income decile was 2.1% in 2005 and 2.8% in 2015.<sup>40</sup>

## Consumer views on the poverty premium in energy

The poverty premium in energy was perceived as unfair by low-income consumers. Many interviewees and participants in the discussion group were shocked at the differences in prices, and many were unhappy that low-income consumers paid more, for what they saw as the same thing, using words such as 'unfair', 'disgusting' and 'shocking'. Some thought it particularly unjust that those on lower incomes paid the penalty.

*It's like going to a fruit shop and they go: "If you have this bunch of bananas, it's £5. But if you have the bunch of bananas that's been delivered yesterday, it's £10." It's gas and electric they're selling. Whether it's variable or fixed. Man, Single, no children, Birmingham*

*Everyone should be paying the same price ... Man, Couple with children, London*

*What gets me is, I don't see why people who are like where I live with very small incomes, they've got the prepayment, they're paying a hell of a lot more, and I don't think that's right. ... And I wouldn't mind paying a little bit more on my bill, to compensate. Man, Couple with children, London*

*I think you do pay more for being on pay-as-you-go, but really that's unfair because actually it's the people who haven't got as much money usually are on the pay-as-you-go ones. Woman, Lone parent, Birmingham*

## CHAPTER 3: WHY THE POVERTY PREMIUM ARISES

Drawing on our fieldwork with low-income consumers as well as literature from regulators and academics, this chapter explains the factors underlying the poverty premium in energy.

These factors can broadly be divided into demand-side factors which are consumer-facing, and supply-side factors that are industry-facing.<sup>41</sup> We focus on factors that either affect only low-income consumers or those that have a disproportionate impact on them.

**Figure 3: Factors affecting the poverty premium in energy**

Demand side	Supply side
Less capacity for decision-making as a function of living on a low income	Cost-reflective premiums
More limited access to enabling products	Market competitiveness in sub-markets
Lower levels of literacy, and digital and financial literacy	Complexity of products / information
Greater limitations of choice due to housing circumstances	Cross-subsidy of others in the market
Behavioural traits such as preference for control over spending	
Higher levels of indebtedness which impedes switching	

### Demand-side

#### Less capacity for decision-making

There is growing empirical evidence that being on a low-income can result in reduced capacity for making decisions (note, we are not implying here a lower level of intellectual capability).<sup>42</sup> In part, this results from the strain of having to make many important and stressful choices as part of budgeting on a low income. For instance, social science experiments find that reminding people of money worries just before taking an IQ test reduces a person's cognitive capacity more than going one night without sleep.<sup>43</sup> This is probably a contributing factor to the lack of prior thought that many interviewees had given to who supplied their energy or the deal they were on. It is also likely to be a partial explanation for lower switching levels among low-income households.

#### Limited access to enabling products

Research suggests that, across all markets, low-income consumers who interact with the market offline are missing out on an average £516 per year.<sup>44</sup> Such individuals are less likely to have access to products and services in intermediate markets such as financial services and digital services that are the route to buying the best value services or paying in the cheapest way. This is evidenced by:

- Being unbanked and having to pay in cash. While the proportion of consumers unbanked has fallen dramatically this century from 4.4 million in 2002-03, in 2015/16 there were still 1.52 million UK adults unbanked.<sup>45</sup> They are typically on lower incomes.
- Having access only to a basic bank account and not being able to pay by direct debit.
- Lacking the digital appliances or services to seek out the best deals or buy services online. Take up of telecom services is rising but the latest data reveals that 35% of households in the lowest socio-economic group (DE) do not have fixed broadband, compared to 19% across the whole population. The disparity in use of mobile devices is less marked but still evident (13% compared to 8%).<sup>46</sup>
- Ofgem surveys have found that lower frequency of use of the internet is also correlated with lower switching levels.<sup>47</sup>

### **Lower levels of literacy and digital and financial literacy**

Lower levels of literacy and digital literacy make it difficult for consumers to make informed choices and to use digital tools to help them switch. We heard through the research that literacy levels in Scotland are a matter of concern. The latest comprehensive data relates to 2009 and reveals that 27% may face occasional challenges and constrained opportunities due to their skills whilst 4% face serious challenges in their literacy practices.<sup>48</sup> Those with low levels of literacy are on average on lower incomes.

Many across the UK lack the digital skills to use online price comparison websites or receive communications electronically. Around one in ten UK adults have not used the internet.<sup>49</sup> The proportion of low-income consumers on SVTs is higher among the digitally-excluded.<sup>50</sup>

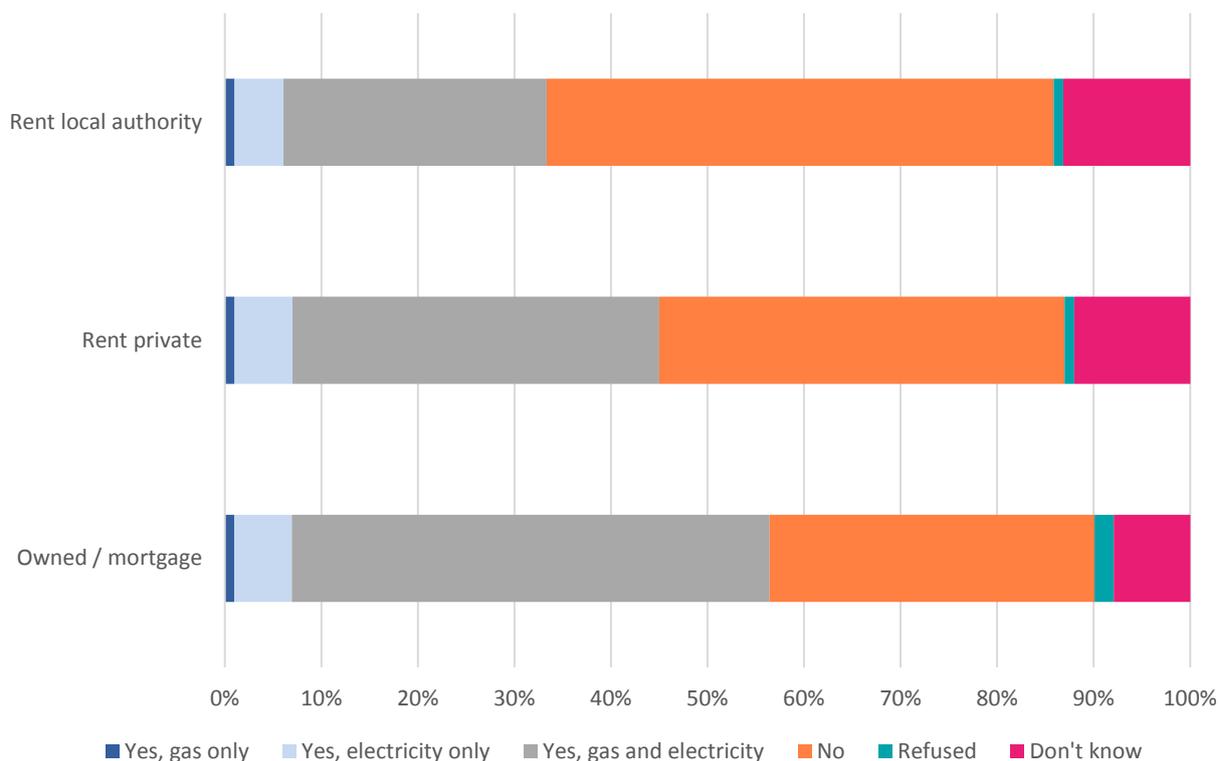
Digital literacy and confidence emerged as a more significant challenge among our interviewees than access to the internet or a computer. While some did not use the internet at all, there were others who used the internet for buying other goods such as through Amazon but who did not use the internet for billing or for seeking out the best deal. This appeared to stem from risk aversion, and for some the belief that switching energy supplier was too important a step to be undertaken online.

Low-income consumers are less likely to choose appropriate financial products for their needs and display a lower level of financial capability. This may arise from less interaction and experience of financial services. This may make it harder for them to understand pricing structures and tariffs.<sup>51</sup>

### **Limitations of choice due to housing circumstances**

As Figure 4 shows, tenants in social housing and the private rented sector are much more likely than homeowners to be on a default SVT than homeowners.

Figure 4: Proportion of consumers on fixed term tariff by tenure



GfK Survey for Ofgem on consumer engagement, 2017. Q11. “A fixed term tariff is a tariff that has a definite end date. Are you on a fixed term tariff for (gas / electricity / gas and electricity)?”

In part, this is likely to reflect their demographic characteristics. However, housing factors also drive the poverty premium in energy. Our research found that consumers often stuck with the payment methods and the suppliers that were already in place in their property when they moved in. In the case of PPMs, some felt stuck because they had been told that they would have to pay to have the meter removed (although in most cases removal is now free of charge); in other cases they had not been motivated to positively switch over.<sup>52</sup> In such circumstances, consumers may therefore find themselves facing a premium simply by virtue of the actions of past tenants.

*It was there when I moved into the property so I had no choice but to have it. Man, Couple with children, London*

*It's when I moved into the property it was already like that and then I didn't bother try and change it. Man, single, no children, London*

Tenants are legally entitled to switch supplier assuming that they, rather than their landlord, pay the bill. In some cases, landlords may have preferred suppliers.<sup>53</sup> In others, tenants may have to gain the permission of their landlord. Given the typical power imbalance between landlord and tenant and the lack of information, this is problematic. One private tenant reported that her landlord had refused her permission to switch away from a PPM.

*He think, I not pay or somebody not pay the bill and he scared, yes. ... If this house is mine? Quickly. Quickly, I'd change. Woman, Couple with children, Birmingham*

For consumers in temporary accommodation or those hoping to move into a different form of housing, the impulse to switch suppliers to move off a PPM may be particularly weak.

*I've wanted to go back on bills, but you have to pay to go back on the bill. I can't afford that and, like I said, I don't really want to be [in the flat] for long. Woman, lone parent, London*

### **Behavioural factors**

A range of behavioural traits exhibited by low-income consumers mean they are less likely to switch suppliers and to opt for non-standard payment methods. These behaviours are a consequence of functioning on a low income.

Households on a low income often seek to control their spending tightly. As previous SMF research has shown, many manage their budget on a weekly cycle and assign specific incomes to particular outgoings.<sup>54</sup> Budgeting in cash is not uncommon because of past experiences with direct debit payments and bank charges, and as a means of exercising control.<sup>55</sup> Volatile incomes may make it problematic for households to commit to regular payments to suppliers and lead them to avoid direct debits.

For such reasons, many interviewees identified some positive features of being on a PPM.

*Much easier than receiving a bill for two or three hundred, and you just haven't got the money to pay it. Man, Single no children, Birmingham*

*You know where you stand, you know what you're using, you know you can afford it, or you can't, and you're not hit with a big bill. That's the pros. The cons are, if you don't have money at that time you won't have heating. Woman, lone parent, London*

Simply forcing consumers onto mainstream payment methods is likely therefore to have negative consequences for household finances. Research in Scotland has found that 38% of consumers report less hassle and more convenience as a reason for using PPM, whilst 33% cite the fact that it is easier to monitor usage and expenditure.<sup>56</sup>

The same factors may affect other consumers making them intolerant of estimated billing and averse to direct debit payments.

*Again, it's something that I feel more in control of. With direct debit, you're not seeing it, you're not perceiving it, when it goes in and out of your account. Woman, lone parent, London*

*I don't like direct debits because ... I like to know exactly what I've used and pay for that. Woman, couple with children, London*

*I was on direct debits on my gas but cancelled it because I paid monthly by direct debit but every time I got a bill, it was a "what'sit" bill, you know an assessed bill and they always assessed it more. Man, Single no children, Birmingham*

Low-income consumers may be less ready to take the risk of switching their energy supplier as the impact of overlapping payments, facing unexpected charges, or being locked into tariffs that end up being expensive is perceived to outweigh the benefits. Research by Citizens Advice Scotland found that those who had negative experiences of switching would not consider switching again, with a common problem being unaffordable bill overlaps.<sup>57</sup>

The desire for control also prompts some consumers to opt for paper rather than electronic billing. For instance, one consumer put her paper bills in her diary so that she knew when she would need to make a payment.

*I prefer to receive bills in paper.... I can put them in my diary and when I get one, I'll put it in the diary two weeks ahead and then when I'm flicking through my diary, I'll know that's when I've got to pay that bill. That just makes me feel a little bit in control. Woman, lone parent, London*

### **Indebtedness impedes switching**

Indebted consumers can find it difficult or impossible to switch suppliers or to switch from a PPM to a billing account. Ofgem has been working with the industry to encourage suppliers to be more generous in their treatment of indebted consumers. We heard examples of suppliers writing off debts for the most vulnerable. Regulations now stipulate that consumers with debt levels of below £500 must be allowed to switch supplier through the debt assignment protocol.<sup>58</sup> Switching levels have increased, though the overall proportion of successful switches via the Debt Assignment Protocol remains very low at 5%.<sup>59</sup>

### **Supply side factors**

The energy poverty premium is also influenced by the behaviour of suppliers and the structure of the market. Many of these factors interact with, and exacerbate, demand-side factors. For instance, risk aversion among low-income consumers may increase if supplier behaviour results in bad switching experiences; whilst complex and confusing tariffs will be especially hard for low-income consumers to assess given their relatively more limited capacity for making decisions.

### **Cost-reflective premiums**

Services provided to low-income consumers may be more expensive for companies to supply. As such, firms may seek to recoup these additional costs.

- Historically, PPM consumers have been more expensive to serve than other consumers because of the costs of installing meters and of processing payments. Ofgem has acted to prevent suppliers from charging above cost. For instance, regulation SLC 27.2A requires that “Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods”.<sup>60</sup> In its 2015 review, Ofgem remained concerned that charges for installation did not always follow this rule.
- A 2015 review of PPMs found that costs of removal varied from £47 to £160 but that 95% of meter removals were carried out for free. As noted above, our interviews revealed that the costs of removal – real or perceived – still deter consumers moving off PPMs.
- Paper billing costs suppliers more than communicating by email.

- Suppliers offer discounts to consumers to pay by direct debit as it reduces the costs of payments and reduces the likelihood of consumers going into debit. Ofgem regulations stipulate that such discounts must be cost-reflective.<sup>61</sup>

### **Market competitiveness in sub-markets**

As part of a universal service obligation, energy suppliers cannot refuse to supply a household, apart from in exceptional circumstances. However, lower income consumers may have less choice of suppliers and tariffs. This may be because suppliers deliberately refrain from marketing some products and services to low-income consumers.

This is a factor in the PPM market. There are fewer tariff choices available for PPM consumers, and in 2015 Ofgem reported that ‘competition seems weaker in this segment of the market’.<sup>62</sup> The regulator concluded that this occurred because suppliers viewed PPM consumers as less attractive than other market segments (being higher cost to serve and lower usage consumers on average).<sup>63</sup>

More generally, suppliers may compete less aggressively and offer fewer suitable deals to lower-income consumers than to higher-income consumers. In 2013, Ofgem allowed firms to offer tariffs with no standing charges.<sup>64</sup> Some interviewees volunteered that they had switched to a supplier with no standing charge as a tactic to match the charging structure of the tariff to their (lower) consumption patterns.

However, tariffs without standing charges are rare among the Big Six and only available from a small number of providers in the market. Ofgem notes that since the PPM price cap was introduced the number of suppliers offering such tariffs in this segment of the market has halved from four to two and ‘as a result, some low-use electricity prepayment customers are likely to have seen their bills increase from April, and the alternatives available to this group have fallen.’<sup>65</sup>

### **Complexity of products / information**

Professor Dieter Helm argued in his recent review: ‘Some of the practices of the major suppliers have added to the stickiness [of consumers], by offering multiple tariffs, reducing the ability of customers to understand what is being offered to them, and reducing trust as some customers who switched ended up worse off.’<sup>66</sup>

Complex tariff structures combine with demand-side factors to leave many low-income consumers on sub-optimal products. Choice overload may simply deter consumers from acting.<sup>67</sup> Those who do switch may end up on a sub-optimal deal. Previous research shows that low-income consumers who switched were less likely to have received a saving than more affluent householders.<sup>68</sup> Interviewees were almost unanimous in finding energy tariffs and bills excessively complex and difficult to understand.

*Standing charges, yes. I can't work it out because basically, I'm even still not sure, do all of the providers have the same amount of charge. Man, Single, no children, London*

*For me, switching is quite complicated. Trying to figure out the fixed way and the variable way and all these other terms that they use. Woman, couple with children, London*

*It's not really fair because they're using that confusion to make money unfairly. Woman, lone parent, London*

Regulators have acted repeatedly to try to reduce the complexity of tariffs. In 2013 Ofgem introduced a rule that limited each company to four tariffs, but the CMA subsequently recommended that this rule be removed as it was considered to limit supplier innovation.<sup>69</sup>

### **Cross-subsidy of others in the market**

In energy, low-income consumers may subsidise higher-income consumers. This occurs because energy suppliers are able to identify consumers who are less responsive to price signals and more likely to stick with their supplier, and can thus offer them more expensive deals knowing that they are very unlikely to switch to an alternative supplier; these are more likely to be lower-income consumers.<sup>70</sup> Suppliers can then reserve the better-deal products (some of them indeed may be loss-making) for more price-elastic consumers, who tend to be more affluent. This situation has led the Secretary of State Greg Clark to describe a two-tier market in energy – a (comparatively small) highly competitive market for active consumers who switch regularly; a (comparatively large) market with weak competition where consumers rarely switch and get offered poor SVT deals.<sup>71</sup> Therefore, the energy market is stuck in an equilibrium which advantages very active consumers and disadvantages already deprived consumers. It may not be in the interest of any single firm unilaterally to raise its best fixed terms deals and lower its SVT, as this would mean it could expect to lose active consumers who would switch away to a better deal, whilst its profits from its loyal consumers would fall.

### **Network infrastructure**

The availability of different forms of energy is dictated by the network and the distribution of the rural population. Ofgem analysis has shown that off-gas households are more likely to be in severe fuel poverty and that households using electric heating tend to be on a lower income.<sup>72</sup>

We do not discuss this dimension in depth in this study as the types of necessary policy responses are qualitatively different as households are excluded from a service (e.g. gas supply) rather than paying more for it.

### **How factors change over time**

It is important to note that factors that drive the poverty premium change over time, influenced by policy, regulation, technology and innovation. This is evident in other markets – for instance pay-as-you-go mobile consumers historically paid a premium for being off-contract. This is no-longer the case, following cheaper payment methods and the entry of Giffgaff. The result is that tariffs are similar for PAYG as for contract deals (although low-income consumers may still face a premium in the telecoms market because of their lower propensity to switch regularly).

Below we describe how the poverty premium in energy is evolving with time:

- The premiums paid by PPM consumers because of cost reflexivity are declining as processing of payments is becoming digitalised and cheaper; meanwhile smart meters are providing an alternative physical infrastructure. The remaining challenge is how to further reduce the premium.

- As renewable and household energy generation increases, a larger number of homes will have access to their own energy or other local sources of energy. Given that wealthier households are much more likely to have the necessary capital to make investments in domestic energy generation, they will have more independence from the market. A situation may arise where most of the population have access to independently-generated energy, leaving a minority of (lower income) households reliant on the market. This premium could be addressed by proactive capital subsidy of low income consumers or the landlords who house them.
- Take-up of energy efficiency measures across different households is likely to impact the poverty premium faced by different households over time. Existing energy efficiency schemes have prioritised improvements to the homes of low-income consumers. However, take-up of these initiatives has been uneven.
- The data revolution and smart meters could offer new opportunities for suppliers to price discriminate against low-income consumers. This could occur if suppliers can identify less engaged consumers and charge them higher prices.
- Consumption patterns may alter with low-income households consuming less fuel. Analysis by the IFS suggests that households in the lowest income quintile reduced their consumption between 1974 and 2011 to a greater extent than other households, driven largely by a reduction in consumption of fuels such as coal and oil.<sup>73</sup> If the consumption level of low-income consumers falls in the future then this could make typical products even less appropriate for them.

## CHAPTER 4: POLICY RESPONSES

This chapter describes the range of policy responses that can be taken to address the experience of the poverty premium to address the underlying factors.

### Range of policy measures

Our analysis identifies four types of measures that policymakers could take to address the factors identified in Chapter 3 and to reduce and eliminate the poverty premium in energy. Table 2 groups all the policies that we have considered into four categories of interventions.

**Table 2: Longlist of policies considered in this project**

<p><b>Intervene in supply structures</b></p> <ul style="list-style-type: none"> <li>Regulating supplier practices</li> <li>Setting up new suppliers</li> <li>Applying social pressure to suppliers</li> <li>Community or household generation schemes</li> <li>Reforming tariffs</li> </ul>	<p><b>Demand-side support</b></p> <ul style="list-style-type: none"> <li>Providing advice to consumers</li> <li>Reforms to the switching process</li> <li>Enabling collective switching and buying in bulk</li> <li>Maximising benefits of smart metering</li> <li>Kitemarking products or providers</li> <li>Ensuring better information for consumers</li> <li>Activating third parties such as landlords</li> </ul>
<p><b>Intervene through other markets</b></p> <ul style="list-style-type: none"> <li>Financial products</li> <li>New payments systems</li> <li>Digital services and digital literacy</li> <li>Widening choice via digital inclusion</li> </ul>	<p><b>Provide subsidies</b></p> <ul style="list-style-type: none"> <li>Via taxpayer (e.g. Winter Fuel Payment)</li> <li>Via other consumers (e.g. Warm Home Discount)</li> </ul>

Through the research process we sought to test which policies would have the most significant impact on addressing the poverty premium. We prioritised policies which had potential to address the prevalence and scale of the poverty premium. As secondary considerations, we also prioritised policies which:

- are politically plausible in the current context;
- are affordable to the state;
- have a positive or at least neutral effect on other consumers who might be paying a premium (e.g. older consumers);
- have positive or at least neutral implications for competitiveness and innovation in the market; and,
- have positive or at least neutral implications for the environment and green energy supply.

Appendix 1 provides more detail on how our longlist of policies were rated against these different considerations. However, high-level arguments are set out below.

First, regulators and governments have focused significant attention on improving the demand side of the market. This has included: changes to tariff structure, measures to promote switching, and measures to make switching easier and more predictable. As Ofgem has noted, there have been increases in the switching rates, but these have been modest and slow and from a low base: from 14% to 18% per year across the whole market and from 11% to 15% among consumers on incomes below £16,000.<sup>74</sup> The CMA's review put forward additional measures that will come into force in due course, including a database of inactive consumers which will be made available to competitor firms.

Recent evaluation of pilots suggest that such initiatives could have a positive effect. In a pilot, consumers received a Best Offer Letter from the CMA, offers from other suppliers or neither. Over a three-month period 5% of consumers subject to the offers or letter switched to an external supplier, compared to 2% of the control group.<sup>75</sup> Trials of consumer responses to a 'Cheaper Market Offer Letter' (where consumers receive a standalone letter with three cheaper offers) also revealed an increase in switching rates. Among those who were contacted 2.9% switched in a 30-day period, compared to 1% of those who weren't contacted.<sup>76</sup> It is not clear how these 30-day switching figures would translate into annual switching rates – it would be optimistic to assume that such additional switching would occur each month if the consumers received letters repeatedly throughout the year.

These are promising initiatives, which should continue to be pursued. However, it is unclear how these measures will ensure that a majority of currently inactive consumers switch regularly. Meanwhile, as the University of Bristol has argued, and as Chapters 3 and 4 demonstrate, there are a wide range of behaviours 'borne of need and circumstance' among low-income consumers which are unlikely to be addressed by improving awareness, skills and perceptions.<sup>77</sup>

Second, our policies focus on the energy poverty premium. We therefore focus less on mass market solutions except where we feel these could deliver specific benefits to low-income consumers. Finding ways to encourage those who already switch to switch more often is not the answer to the problem we are addressing.

Third, we note that there is significant flux in the energy market driven by policy intervention and technological change. The price cap for PPM consumers and the Safeguard Tariff are prominent policy decisions in place. The roll-out of smart meters is another.

Fourth, we emphasise that it would be perfectly possible for the government to eliminate all aspects of the PP by nationalising all industries and dictating prices and practices. By definition, there would be no variation. However, the actual challenge is to retain as far as possible the positive dimensions of the market – competition, efficiency and innovation – whilst addressing unfair variation. As Donald Hirsch has argued, one form of market failure is where tariffs are so complex that consumers cannot accurately choose the best one, but another form would be if all suppliers provided exactly the same product at the same price – all consumers, including those on low incomes, would lose if a lack of effective competition resulted in higher prices.<sup>78</sup>

Below we describe eight policy steps that the Government should take. These include proposals on how the Government could take forward existing programmes and policies such as the price cap and smart meter roll-out as well as new proposals for governments in Westminster, devolved administrations and city mayors to consider.

## Policies to reduce the poverty premium

This section details policies that could reduce and potentially eliminate the poverty premium in energy. It separates them into four categories: supply side, demand side, subsidies and intermediate markets.

### Subsidies: Identifying and targeting low-income consumers through the Warm Home Discount

Bill reduction schemes do not address any of the underlying causes of the poverty premium. However, they do mitigate its impact for those who experience it. Moreover, currently, there is no effective way of identifying low-income consumers in the energy market and no reliable means of distributing subsidies to them.

To this end, we recommend radically reforming the Warm Home Discount (WHD). Getting this right will help direct financial support to low-income households as well as ensuring that they can be identified for the purposes of other policies. This is particularly important given the fact that the WHD is funded by consumers - including those low-income households who currently don't receive the rebate.

#### What is the Warm Home Discount?

The WHD was brought into being through the Energy Act 2010. The WHD provides a voucher rebate for energy services worth £140 per year for designated households. Participating suppliers include any with over 250,000 domestic customer accounts, plus others who have elected to take part.<sup>79</sup>

It sits alongside suppliers' Priority Service Register which enables vulnerable customers to access additional services such as customer service and emergency support. However, consumers have to agree to be placed on this register and coverage is patchy.<sup>80</sup>

#### Problems with the Warm Home Discount

Through our events and fieldwork, we identified a wide range of problems with the existing WHD scheme corroborating concerns cited by Ofgem, BEIS and a range of NGOs.

- The rules are confusing and mean that some working-age low-income consumers are not eligible. All participating suppliers must provide the benefit to the Core Group.<sup>81</sup> This comprises those in receipt of the Guarantee Credit element of Pension Credit (no Savings Credit). Suppliers also provide the WHD to a 'Broader Group' who 'are in or at risk of fuel poverty'.<sup>82</sup> Each supplier has its own eligibility criteria for the 'Broader Group' although they must include specific consumers such as those in receipt of Income Support, ESA and JSA.<sup>83</sup> Low-income consumers may be excluded because they do not receive the required benefits, for instance if they are working more than 16 hours a week.

- Many working-age consumers who are eligible for WHD do not receive it. To receive the WHD, people must apply and thus be aware of the scheme and complete the application process. Moreover, different suppliers have different rules on eligibility and different deadlines for applications. Among our research participants, not all consumers on eligible benefits received the WHD. This is less of a problem for pensioners who are identified using administrative data.

This problem is aggravated because, even if a consumer is eligible and completes the application in time and accurately, they may not receive the rebate because non-Core spending is capped and paid out on a first-come first-paid basis.<sup>84</sup>

National Energy Action has reported that of the estimated 2 million working-age households who should be eligible for support through the WHD 'Broader Group', only 836,201 rebates were made in 2015-16.<sup>85</sup> Separately, in 2014, the Children's Society estimated that about 1.9 million children living in poverty (over half of all children in poverty) are in families that do not get a Warm Home Discount.<sup>86</sup>

- Consumers must receive their energy from a participating supplier thus reducing their choice and their readiness to switch. Some interviewees noted that their choice of energy supplier was limited due to the rules on which suppliers offer the WHD. This disincentivised them from switching.

*Male Respondent: We are with [X supplier] because, like I've said, I've spoken to the missus before about moving over but she says "no", just because of that reason: we get the Warm Home Discount.*

*Interviewer: Let's say that you could get the Warm Home Discount with a new provider would you...-*

*Female Respondent: I'd switch at a heartbeat.*

This situation is bad for the consumers concerned – who may incur significantly higher costs if they stick on a SVT with their existing supplier. It is also bad for competition in the market.

- Interviewees noted that sometimes the rebate was paid after the winter when it was of less use for keeping the home warm. This concern was also raised in response to the Government's consultation on the WHD in 2016/17.<sup>87</sup>

*The problem is you sometimes don't get them when you need them. You'll get them when it's getting warmer [Laughter]. Woman, lone parent, London*

Interviewees were not asked about the adequacy of the WHD, and they did not volunteer information on whether it was sufficient. It should be noted that the WHD represents about 12% of the average SVT offered by the Big Six suppliers.<sup>88</sup>

**Policy recommendations:**

We recommend that the WHD should be reformed to provide a clear mechanism for identifying vulnerable households, improve take-up and establish a system that is based on need rather than funding availability.

- Recommendation: The criteria for eligibility for the WHD should be standardised and cover low-income households.
- Recommendation: The rebate should be available from all suppliers. If necessary, the Government should reimburse smaller suppliers for the costs of the WHD where they are incurred.
- Recommendation: Eligible consumers should be identified and made eligible automatically, so that households in need do not go without support. The NAO has previously argued that the government and regulators generally should ‘consider developing a system to allow firms to easily establish consumers’ eligibility for support schemes based on receipt of means-tested benefits’.<sup>89</sup>

This could be done through the ‘Better Use of Data in Government’ initiative, which is currently being taken forward through the Digital Economy Act (DEA). There is provision within this to share data to assist those at risk of fuel poverty.<sup>90</sup> The Government has accepted that the DEA is central to the improvement of targeting of the WHD and Ofgem is proposing amendments to the DEA to reflect this.<sup>91</sup> This idea has recently been put forward by the House of Commons, Business, Energy and Industrial Strategy Committee.<sup>92</sup>

- Recommendation: Greater efforts should be taken to ensure that rebates reach households before the winter.

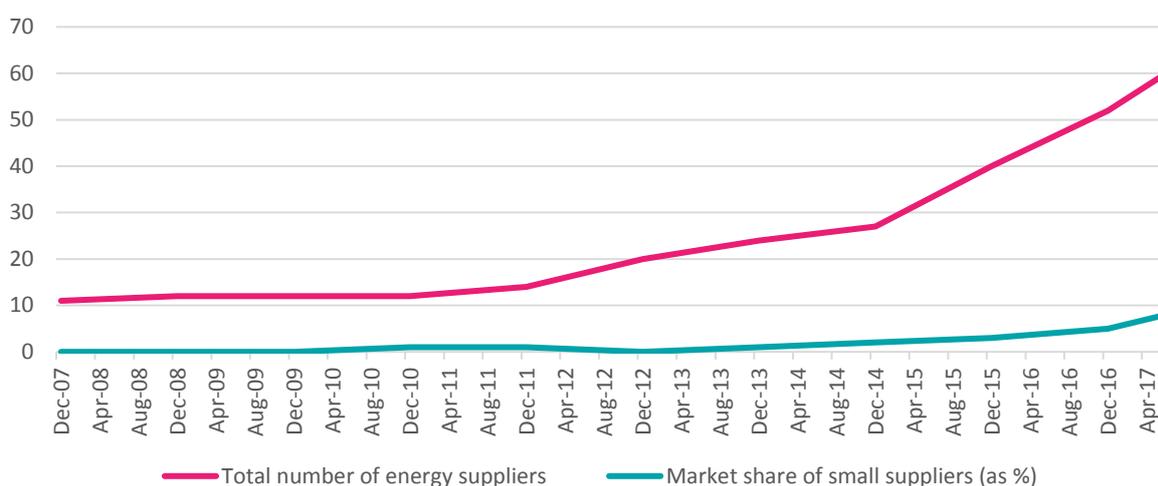
## Supply side: Introducing new public-sector suppliers

There are already existing public-sector suppliers operating in the energy market, including Robin Hood Energy and Bristol Energy.<sup>93</sup> The Scottish Government and the London Mayor are also committed to introducing their own state suppliers.<sup>94</sup> In its Energy Strategy, the Scottish Government argues that this could help address a central concern around trust in the market and is aiming for an operator to be running by 2021.<sup>95</sup> Clarity is needed on what benefits these social suppliers can bring to low-income consumers.

### Understanding the case for a government supplier in the energy market

The case for a state supplier is often particularly strong where greater plurality and diversity of supply will increase competition in the market on either price or a dimension of quality. As past SMF research has shown, the energy market suffers from concentration, which damages competition.<sup>96</sup> However, it is not the case that there is a shortage of suppliers in the market. In fact, the number of small suppliers has grown significantly as has their share of the market.<sup>97</sup>

**Figure 5: Growth of smaller providers**



Source: Ofgem data. <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

The case therefore for an additional state supplier needs to be considered carefully. Apart from in the PPM market, the problem is not a lack of products or choice in the market, and consumers stuck on poor value deals are not excluded from the best deals; instead, consumers do not purchase the best offers on the market. Creating a state supplier would have no positive effect on the poverty premium if the supplier only attracts those who recently or regularly switched – such consumers already benefit from good deals. The policy would only be effective if, because of the presence in the market of a state supplier, a larger number of consumers switched providers.

It is difficult to confidently assess the prospects of this. Previous research has suggested that consumers favour new entrants compared with the Big Six when they are switching.<sup>98</sup> However, this does not mean that a new state supplier would have a greater impact than a new private entrant. A more compelling argument is that the energy market is caught in a low-trust equilibrium and that a state supplier could help disrupt this. Although there

have been some marginal improvements in recent years, Ofgem notes that consumer trust in the energy market is low compared with other sectors (see Figure 6).

**Figure 6: Trust levels among energy consumers**



Source: Ofgem’s engagement survey, 2017, Q63, 64, 68

Our research indicated that the absence of trust dulls the incentive for consumers to switch because they are not confident they will get a good-value service from a new supplier.

*I fear being conned. I fear once I switch, then things will go wrong with my supplies. ... The fear and the anxiety that it will cause me, I know, will override any savings I make ..., so it's almost like better the devil you know. Woman, Couple with children, London*

*I think I'm quite suspicious of these energy companies, to be honest with you. I think there's a sense with me that better the devil you know. Woman, Lone parent, London*

Some also felt that there was no differentiation between the behaviour of the suppliers and that therefore there was no point switching.

*I feel they're all very much the same, aren't they? They make you all these promises... Woman, Lone parent, Birmingham*

In contrast, focus group participants were positive about the idea of a government provider. In part, this was simply because it could be trusted, as it would not be seeking a profit. Indeed, many were ready to pay a premium to be with a provider that was non-profit making. Some participants indicated that they would be more likely to switch if there was a government supplier as an option. This suggests that a state supplier could have a positive effect by activating consumers to switch. It remains hard however to

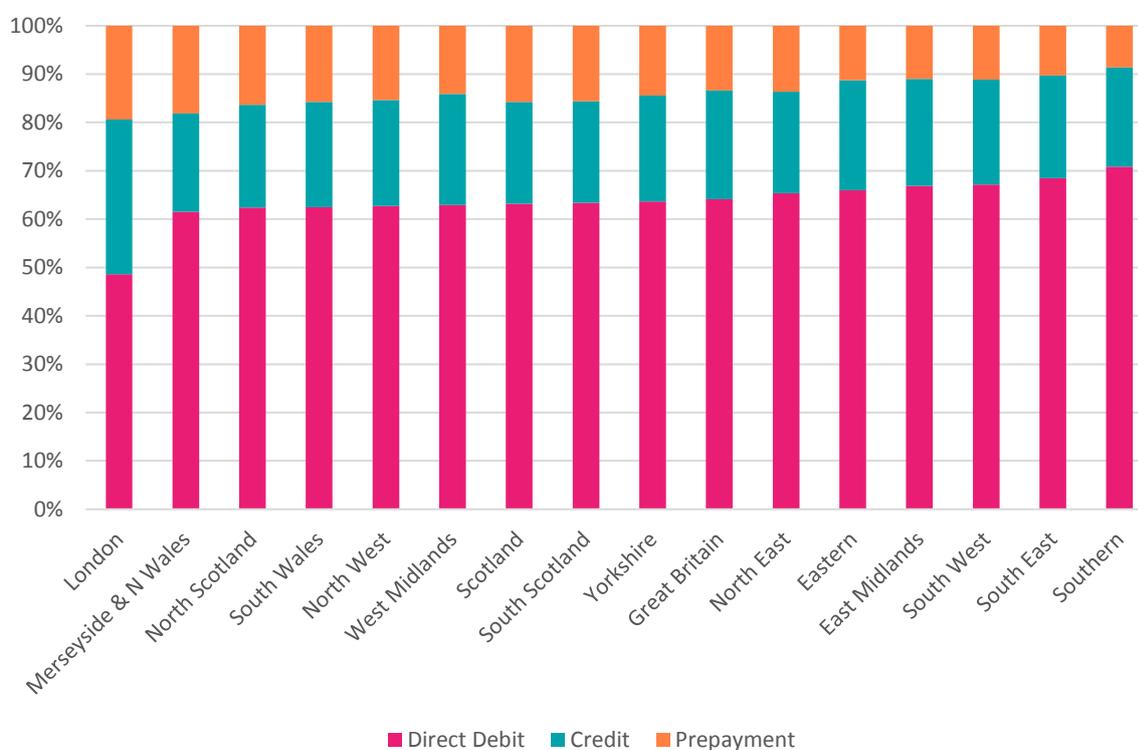
estimate the potential impact and how far positive views would translate into consumer action. For instance, the anticipated effect on switching may be lower than participants reported, as they were surprised that there are already not-for-profit suppliers in the market. Consumer inertia may persist despite higher levels of trust.

### Considerations in introducing a social supplier

Establishing a state provider comes with risks which must be managed carefully. As the OECD has argued on the role of state-owned enterprises, ‘due to their privileged position State-Owned Enterprises may negatively affect competition and it is therefore important to ensure that, to the greatest extent possible consistent with their public service responsibilities, they are subject to similar competition disciplines as private enterprises.’<sup>99</sup> The first problem is that the government may establish terms or conditions that favour the state supplier thus undermining competition. For instance, regulators have voiced concern that more favourable terms have been offered to state operators in parts of the European rail market where such operators compete with private suppliers.<sup>100</sup> Second, competition may also be undermined if state operators receive an explicit or implicit state subsidy derived from the lower costs of capital. Third, policymakers should also be alert to the risk that governments may be unready to let public-sector suppliers fail.

At the same time, energy markets vary significantly by region. This may mean that a local or regional supplier could seek to compete in a specific way to increase competitiveness in a segment of the market. For instance, London has a high proportion of consumers on PPMs and paying by credit for their gas.

**Figure 7: Regional variation of payment method for gas, September 2017**



Source: Ofgem data. <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-price-stastics>

**Policy recommendations**

- Recommendation: Governments should ensure that state energy suppliers are not subsidised by taxpayers otherwise this will distort the market and undermine competitiveness.
- Recommendation: The introduction of new state suppliers should be informed by research on the impact of existing state suppliers and by behavioural experiments that assess whether low-income consumers are more likely to switch suppliers if a public-sector supplier is in the market.
- Recommendation: New public-sector operators should focus primarily on brand, product design and distribution rather than competing on the wholesale market, given the primary benefit of a public-sector supplier is that it could increase trust and engagement in the market. New operators should consider sharing resources and infrastructure with other suppliers. Given the strong brands of city mayors, they may be well-placed to develop strong brands that offer a good deal to consumers.
- Recommendation: New state suppliers should assess how local consumers experience the poverty premium. For instance, in London, payment methods appear to be a challenge.
- Recommendation: The UK government should not set up a national operator. National Government's role is to regulate the market effectively and encourage consumers to participate in the market. This message could easily get confused if the Westminster government seeks to promote an energy supplier.
- Recommendation: The purpose and message behind any government supplier should be clear otherwise it may simply further reduce trust in the market if it promises outcomes it cannot deliver. A social supplier can seek to offer the best energy deal in the market. However, just because it is not-for-profit does not mean that it will necessarily offer the best tariffs in the market. The tariffs that any supplier could offer will be affected by efficiency levels and by hedging strategies. Indeed, precisely because it may not price-discriminate, a social supplier is unlikely to be able to offer the best deal in the market to active switchers.

## Supply side: Designing the price cap for low-income households

While a cap on the price of energy will help those who experience the poverty premium in the short-term, it will also contribute to a less competitive market and have negative implications in the longer-term. The Government's focus should be on ensuring that low-income consumers are included in the scheme, creating a simple policy that can inspire confidence and boost trust in the market, and lifting the cap as early as possible.

### The policy and proposals so far

In its 2016 Energy Market Review, the CMA proposed that the regulator should introduce a price cap for PPM consumers but not for other consumers. From April 2017, the prices faced by PPM consumers were capped by Ofgem. The cap will remain in place until 2020.<sup>101</sup> Ofgem estimated that the cap would benefit around 4.5 million consumers.<sup>102</sup>

In its 2017 election manifesto, the Conservative Party committed to introducing a cap for consumers on SVTs. Subsequently, the Secretary of State asked Ofgem to introduce a cap. Ofgem introduced a temporary 'vulnerable customer safeguard tariff' in February 2018 which covers consumers in receipt of the Warm Home Discount. The price will be set at the same level as for the current safeguard tariff for customers using PPMs. It will affect around 1 million consumers and save eligible dual fuel consumers an average of £120 per year.<sup>103</sup> Ofgem has also committed to extending this price cap to a further 2 million vulnerable consumers in winter 2018/19 if parliament has not approved an alternative policy by then.<sup>104</sup>

The Government has brought forward a bill for a price cap that would affect a further 11 million consumers. The cap will be in place until 2020 and can be extended until 2023 without further legislation.<sup>105</sup>

### The trade-offs inherent in a price cap

There are inherent trade-offs in imposing a price cap. Central is the additional protection provided to consumers via the cap versus the damaging impact on competition. If all suppliers must offer the same (or very similar) prices, then there is no (or very little) incentive for consumers to switch and therefore there is no (or very little) competitive pressure on firms to offer a better value deal. In turn, this means that firms have no (or very little) incentive to invest and to innovate, and therefore prices over time will be higher than they would otherwise be. The regulator can allow a degree of competition by permitting a level of variation in prices (as for instance through the 'headroom' in the PPM cap), but it does this at the expense of lessening the protection it offers to consumers.

It is important also to consider how consumers will interpret the price cap and consequently how suppliers will set their prices. Ofgem accepts that the introduction of the cap is likely to reduce eligible customers' incentives to switch because the gain from switching will be smaller than it otherwise would have been.<sup>106</sup> Separately, Ofgem research shows that price is a motive for the decision to switch for 91% of consumers.<sup>107</sup> Consumers may interpret the regulation as a signal that they do not need to seek out the best deal in the market, because they assume that the regulation is ensuring that they are getting a low-cost product – thus allowing firms to implicitly collude on prices. The latter has occurred in stakeholder pensions, in university fees and in some instances in the high-cost credit market in the USA (though this did not occur in the UK short-term credit

market).<sup>108</sup> In Australia, price caps have been shown to lead to lower levels of consumer engagement and a reduction in the proportion of consumers receiving discounted offers.<sup>109</sup> A price cap could also have a negative effect on consumption levels by artificially lowering prices and thus sending the wrong signal to consumers about energy consumption. New entrants will have less incentive to enter the market if the prospect of gaining a customer base and profits are limited.

Early Ofgem analysis following the introduction of the PPM cap indicates that prices converged in both gas and electricity. For instance, while most suppliers lowered their gas tariffs, one supplier raised them. This suggests that while most consumers benefited, some lost out. Citizens’ Advice report that the difference between the highest and the lowest PPM tariffs has recovered to a similar level after initially compressing.<sup>110</sup>

**Recommendations: Design principles to address the poverty premium**

Ofgem notes that its use of the WHD as a proxy for its Safeguard Tariff is very imperfect. This is because, as noted earlier, the WHD is not taken up by some consumers who are eligible for it and because some low-income consumers are ineligible for it. In the absence of a reliable method for targeting low income consumers, the Government’s proposal of a cap on all SVTs is the best short-term option.

- **Recommendation: The Government’s proposed coverage of all consumers on SVTs in its draft bill ensures that the cap would address the PP and should be pursued. A reformed Warm Home Discount would provide an effective tool to target the cap.**

**Table 3: Comparison between a relative and absolute cap**

	<b>Relative</b>	<b>Absolute</b>
<b>Advantages</b>	<p>Potential for competitive part of the market to drive price reductions in the currently uncompetitive part of the market.</p> <p>Would permit greater competition on quality.</p>	<p>Simplicity – as the tariff can be set precisely.</p> <p>Most likely to instil confidence in the market.</p> <p>Highest level of regulatory protection.</p>
<b>Disadvantages</b>	<p>May push prices up if suppliers see greater commercial gain from keeping tariffs high for loyal non-switchers compared to competing on price for active switchers.<sup>111</sup></p>	<p>Requires the regulator to assess the price at which energy can be supplied economically and then updating this each year. This gets more problematic the longer the cap is in place because as time goes on the regulator has to make more assumptions about how the expected economics of supplying energy have changed in the intervening years.</p>

Table 3 describes our interpretation of the pros and cons of a relative cap (each supplier would have to limit any variation between their best and worst tariffs) and an absolute cap (the regulator would determine the maximum price that a supplier could charge). On balance, an absolute cap would provide the most concrete protection to those who experience the poverty premium. This is because under a relative cap some consumers could continue to face very high prices compared to the best in the market, if for instance

they stayed with a supplier who choose to achieve the relative target by raising all their tariffs. An absolute cap is also simpler and therefore more likely to address the issue of complexity and trust which concern low income consumers.

In designing an absolute cap, we note that there is merit in Dieter Helm's proposal for Ofgem to design the cap so that there is headroom for the suppliers to compete on the margin.<sup>112</sup> This bears some similarity to the situation in Northern Ireland, where there is a price-regulated energy supplier that offers a tariff that is a 'price to beat' for non-regulated competitors.<sup>113</sup> Headroom for price variation means that the poverty premium will still likely persist albeit at a much-reduced rate: low-income consumers will be more likely to be on the safeguard tariff; whilst more affluent consumers are more likely to have switched to a better deal. This is a price worth paying because it will retain an element of competition in the market.

There is also a danger that the cap works effectively for the average consumer but not for a low energy consumer. This would occur if the cap were calculated based only on an average consumer. This would disadvantage low-income consumers.

- **Recommendation: The price cap should be set on an absolute basis, whilst allowing headroom for competition.**

European Commission research has found that tariff deficits have arisen in some countries where the regulated price is set at a level below that of the economic costs of supply. In Spain, the authorities were unready to increase the regulated prices for 'political and social reasons'.<sup>114</sup> This is unsurprising as it may be hard to raise any cap because the losers can easily identify the loss whilst the gains may be less immediately tangible to the winners.

In short, the risks of keeping the safeguard tariff beyond when it is needed are real and there will be significant political pressure to retain the cap. This suggests that very clear criteria should be established for delaying the removal of the cap. One of these should be that low-income consumers have an alternative prospect of achieving a good deal in the market (see for instance opportunities described below for automatic switching).<sup>115</sup> It is worth noting here that Ofgem have stated that it may consider retaining a price cap for the most vulnerable consumers 'even after the wider price cap is withdrawn'.<sup>116</sup>

- **Recommendation: Clear criteria for delaying the removal of the cap should be established to reduce the risk of the cap remaining in place longer than is necessary. One criterion should be that low-income consumers have an alternative method for getting a good deal in the market.**

Following the introduction of the PPM price cap, some suppliers have withdrawn some zero- standing-charge tariffs, thus reducing choice for consumers.<sup>117</sup>

- **Recommendation: The regulator should remain alert to the risk that suppliers may respond to the cap by withdrawing products that suit consumers with low usage patterns as has been the case in the PPM market.**

## Demand side: Auto-switching consumers onto better deals

Low-income consumers are disproportionately likely to be on poor-value energy deals. Those affected pay can around £300 more than those on the best deals. There have been a wide-range of interventions seeking to activate consumers, but these have had only a marginal impact, and it is unclear why other similar initiatives would have a transformative impact on the deals that consumers get. An alternative solution would be to automatically switch consumers onto a better deal thus significantly reducing the energy poverty premium.

### The case for an automated collective switch

Under collective switching, consumers are grouped together, and suppliers are invited to bid for the right to sell their services to all the consumers in the collective. The supplier that offers the best value deal will be chosen to supply the services. Collective switching can have multiple benefits: mitigating the problem of inactivity among consumers, as all participants who sign up to the scheme have the chance of being put onto on a better deal; increasing consumer bargaining power by negotiating with suppliers as a large group; involving professionals in the switching process; and offering a lower cost of customer acquisition to suppliers (the value of which can at least in part be passed onto consumer). Such schemes may be particularly valuable to consumers who are digitally excluded as they may otherwise be ineligible for the best deals.<sup>118</sup> Ofgem announced in February 2018 that it would trial a collective switch in which 50,000 disengaged consumers will be given an opportunity to have their saving calculated; they will then be offered an exclusive tariff, negotiated for them by an Ofgem-appointed consumer partner organisation.<sup>119</sup>

In the recent past there have been a wide range of collective switching initiatives organised by different intermediaries such as *Which?*, MoneySavingExpert, One Big Switch, iChoose, and Greater Manchester Big Clean Switch Campaign. The outcomes have generally been positive for participants.

However, there have been significant drawbacks. The most significant has been low participation rates. A stylised model by the Centre for Competition Policy found that running a collective scheme which provided explicit opt-in decisions could expect to achieve only a 4% switching rate.<sup>120</sup> The CMA found that there had been an increase in the number of schemes but that the schemes were on average smaller and that they made a modest contribution to the overall churn of consumers in the market.<sup>121</sup> Other challenges include whether the deal finally agreed is suitable to the needs of all consumers in the group.

Because of these concerns around participation and take-up, there is emerging interest in collective switches in which consumers opt *out* rather than opt *in*. As Dermot Nolan, Chief Executive of Ofgem, has argued: 'It's a bit like allowing better deals to find customers, rather than customers having to find the better deals themselves.'<sup>122</sup> This concept is mentioned briefly in Ofgem's call for evidence on its Future Supply Market arrangements.<sup>123</sup>

Below we describe in more detail how an automatic switching scheme could operate and how it could benefit those experiencing the poverty premium.

### Scheme design

We know from behavioural science, that consumers will typically stick to the default option. For instance, only a low proportion of consumers have opted out of the auto-enrolment pension scheme. Those who have stayed in have typically stuck with the default investment fund.<sup>124</sup> This principle is already applied in some other countries to energy supply.

#### Box 2: An automatic switch – international example

A number of States in the USA operate automatic switching schemes. The State of New Jersey has been running one since 2002 following the Government Energy Aggregation Act of 2003. Residents are automatically enrolled into the Energy Aggregation Program, although they can opt out if they like. The State buys energy on behalf of ‘rationally ignorant’ consumers.<sup>125</sup> In 2016, the authority reported that the rate achieved through the auction was lower than that offered by all three of the area’s three utility companies.<sup>126</sup>

Despite the similarities, there are also differences. As the Centre for Competition Policy notes, in New Jersey the Government is contracting one supplier to provide the energy and procuring the energy on behalf of consumers. In contrast, the UK Government would be switching millions of consumers, each of whom would have a commercial contract with the supplier. This raises issues of data sharing and the legitimacy of the government dictating consumer contracts in the market.

Through our primary research and the literature, we have identified a range of challenges that would have to be overcome to make this a viable option. Most interviewees were positive about an auto-switching scheme, assuming that it was fair, and offered them an improved deal.

*Yes. I wouldn't care who. If Father Christmas phoned and said "You're paying £50 electric and gas, I can definitely switch you now, tomorrow, for £40". Okay, get on with it. Man, Single no children, Birmingham*

*Yes. Definitely because it takes the stress out of it doesn't it. If you can trust the body that is doing that, I don't know who you could trust to do that, but if you can, then yes for sure. Woman, lone parent, London*

*Yes, definitely. If its energy, definitely I would. Why not? Like I said, everybody wants a good deal. Woman, couple with children, London*

However, the research also revealed a range of concerns that would have to be addressed as well as some consumers who worried about the loss of control. Concerns included: whether indebted consumers would be able to participate; the need to guarantee it was a better deal and that the price would not change; ensuring that consumers did not face overlapping payments with suppliers; leniency of the suppliers (in terms of debt); communication of what is going on; setting up a central point of information; and, ensuring there were no hidden charges.

*I might be switched to a company I wouldn't want dealings with. Man, Single, no children, London*

*Of course. I'd be very upset if someone switched me without my knowledge. I wouldn't want [it]. Woman, couple with children, London*

*Well, I'm a bit of a control freak, sadly. I'd need to know every single thing, but I mean if it's doing me good I wouldn't see why I would be upset about it, but I like to know what's going on and why. If it was going to benefit me, yes, then automatic, maybe. I don't know. I like to be in control. Woman, lone parent, London*

**Table 4: Auto-switch policy – overcoming the challenges**

Challenge	Policy design response
Identifying consumers to participate	<p>Enrol all consumers who have not switched their energy supplier or product for a given number of years and are not on a fixed term tariff.</p> <p>Following the CMA's recommendations, Ofgem is creating a database of inactive consumers. This includes consumers who have not switched for four years.<sup>127</sup> This would provide a useful starting point.</p>
Coping with large volume of switches	<p>We heard concerns in our research that the industry would be unable to cope with a very large collective switch. This concern has also been raised by academics at the Centre for Competition Policy.<sup>128</sup> If all consumers covered by the proposed Safeguard tariff were to be enrolled in this scheme it would mean some 16.5 million consumers.<sup>129</sup></p> <p>It would therefore be sensible to carry out the auctions in tranches over multiple years. This would mean that some consumers would not benefit immediately. The planned price cap should provide an opportunity to set up the necessary infrastructure and to start to switch consumers. This would also have the benefit of ensuring that smaller suppliers are able to compete effectively and thus help reduce the market share of the largest incumbents such as British Gas.</p> <p>The FTTs agreed with the supplier could be set for two-year periods so that auctions would not have to be repeated so frequently.</p> <p>We propose that low-income consumers should be mixed in with more affluent consumers when they are bundled together to guard against the risk that suppliers would charge higher rates for low-income consumers.</p>
Getting the best rather than a very good price	<p>Given that there are large discrepancies between SVTs and the best deals, it is likely that participating consumers would end up making a significant saving if appropriate selection criteria were applied.</p>
Getting a deal that works for all participating consumers	<p>One objection to collective schemes in general is that the deal might only suit the average consumer in the pool rather than all consumers. This risk could materialise if a household that consumes very small quantities of energy was put on a tariff with standing charges.</p> <p>We note that the risk of consumers being switched from optimal products to sub-optimal products is small, evidenced by the fact that there is already little take-up of tariffs with no standing charges.</p> <p>However, as noted above, consumer buy-in would be conditional on the fact that the consumers would get a better deal.</p> <p>We believe that the risk could be managed in one of two ways.</p>

	<p>First, consumers could be bundled together into lots based on their past consumption patterns. In other words, there would be a high consumption pool, a medium consumption pool and a low consumption pool. This would dramatically reduce the risks that a consumer would end up on an inappropriate tariff.</p> <p>Second, consumers' past consumption data could be used to identify households that should not participate.</p> <p>We would have to be happy to live with a certain level of variation in outcomes.</p>
A policy that works in different regions	The Centre for Competition Policy identify a risk that results from the fact that suppliers do not offer uniform prices across the regions, due to transmission and distribution costs. This could be addressed by carrying out the auctions regionally. This would have the added benefit of making it more likely that local suppliers could participate in the auction.
Managing consumer concerns about loss of control	<p>Some interviewees had concerns about losing existing support or being put on a worse deal.</p> <p>As noted above, it would be important to ensure that all eligible consumers automatically receive the WHD irrespective of the supplier.</p> <p>Consumers would be able to opt out of the scheme. Consumers could have multiple opportunities to opt out. We envisage that there would remain a market for consumers who opted out of the auto-switch scheme though it would likely be thinner.</p>
Ensuring quality customer service	<p>Ofgem data on customer service outcomes even within the Big Six reveal marked differences in quality.<sup>130</sup></p> <p>As in tendering public services, strict minimum customer service criteria could be applied to shortlist suppliers onto the framework.</p> <p>Additional criteria could include supplier's treatment of vulnerable consumers.</p>
Mitigating risk of suppliers going bust	<p>There is already a 'safety net' operated by Ofgem for consumers whose supplier goes bust.</p> <p>Parcelling consumers into smaller lots would mitigate the risk of any provider being 'too big to fail'.</p>
Selecting the right intermediary	Interviewees were clear that the organisation tasked with carrying out the auction should be independent of suppliers. The most popular suggestions were the regulator, the Government itself and a charity such as Citizens Advice.
Disincentive effect on consumer engagement	The Centre for Competition Policy argue that an automatic scheme would reduce the incentive to switch as the costs of not switching would fall. However, it may have a positive effect on suppliers by encouraging them to engage consumers who otherwise may be lost to them through a collective switch process.
Funding the intermediary	The costs of running the scheme could be recouped by a charge on all participants, or it could be funded by an industry levy. The latter would put the costs on all consumers and arguably disincentivise consumers from individual action.
Data protection and privacy law	Care will need to be taken to ensure that the scheme is designed to meet new rules under the GDPR which comes into force in May 2018. <sup>131</sup>
Acquiring consent	Research of municipal aggregation schemes in the USA shows that communities are consulted to approve the aggregation of consumers. <sup>132</sup> This could be replicated in the UK via a general election manifesto or local elections.

### **Policy recommendations**

- **Recommendation:** The Government should trial an auto-switch policy with the requisite safeguards with a view to introducing a nation-wide scheme so that consumers have an alternative means of protection from rip-off tariffs when the price cap is lifted at the beginning of the next decade.

We note that the introduction of this policy could have a profound impact on the market. Suppliers would have to compete for the market. Consumers who opted out of the scheme could be expected to be offered more expensive deals than at present, because there would be fewer consumers paying very high prices and cross-subsidising them. We would expect market share to change dramatically if smaller suppliers were given a chance to pitch for customers.

## Demand side: smart meters

There is significant optimism among policymakers that smart meters (SMs) can help address existing market failures by activating consumers and providing them with better data and information, including helping address low levels of switching among low-income households.<sup>133</sup> Our research suggests that SMs have the potential to significantly erode the remaining costs of PPMs, but that they are only likely to offer a partial solution to other aspects of the PP in the short- to medium- term. The government will have to steer the market carefully to ensure that SMs reduce all aspects of the poverty premium.

### The potential of smart meters

As of 2018, Smart Energy UK report that around nine million SMs have been installed across Great Britain.<sup>134</sup> Meters are installed at no direct cost to the household; instead, the meters are funded by a levy on energy bills. Potential benefits include:

- Enabling quicker and more predictable switching processes.<sup>135</sup>
- Making it easier for consumers to choose a tariff that matches their consumption needs and patterns – this could be particularly important for low-income consumers because they often consume significantly below the average.
- Giving consumers greater information and control of their energy consumption and expenditure. This may mean some PPM users would switch to other payment methods. Early evidence suggests that easy top up facilities are also popular.<sup>136</sup>
- Providing opportunities for greater personalisation of deals, for instance around time-of-use.

We heard through our research both optimistic and pessimistic versions of the future.

*Much better understanding, more control over how much you're spending, yes I like it.  
... Man, Couple with children, London*

*[A smart meter] would actually help in knowing how much energy you have been using in that second per day, kind of keep you in focus. I don't think you could overspend if you are actually seeing what you are doing. Man, Single, no children, London*

Conversely, some consumers were either indifferent or had concerns. One consumer was worried that the meter might give off 'radiation', another that he was being charged more since the meter had been installed. A number of consumers noted that the smart meters might mean you were unable to leave your supplier (which is true of SMETS1 but not SMETS2). For others, it was simply a case of not wanting to have to watch how much energy they consumed. These findings should be seen in the context that surveys reported by Smart Energy UK reveal that only very small proportions cite concerns such as privacy and costs, and higher bills (between 1% and 6%).<sup>137</sup>

*What also concerns me, it is a computer whereby it gives the fuel companies a bit too much power themselves. Man, Single, no children, London*

*Is it kind of a tactic for them to come and get you to stick with them? Because once you got their smart meter, you can't be with another company. Woman, Lone Parent, London*

*I think they are charging more since they changed it over to the smart meter. Woman, lone parent, Birmingham*

*No, I don't have any interest in watching how much I'm paying. Man, Couple with children, London*

### Potential risks to smart meters helping reduce the poverty premium

- Take-up. A Smart Energy survey suggests that the appetite for a SM to be installed is much lower among low-income households compared to the average.<sup>138</sup> Only 42% of low-income consumers report that they are likely to request a smart meter or accept an offer of installation in the next six months. This compares to 48% of all consumers without smart meters.

Our interviewees indicated a wide spectrum of attitudes from enthusiasm, through to indifference, misperceptions and opposition. While performance to date is encouraging, there remains a real risk that those low-income consumers yet to receive a SM could be resistant.

- Availability. We heard instances where engineers considered installing a SM too difficult and refused.
- Outdated technology. SMETS1 have limited capability and are not fully interoperable across all providers. This introduces an additional disincentive for consumers to switch (beyond the barriers that already exist). SMETS2 which have greater functionality are now also being rolled out, although from July 2018 SMETS1 will no longer count towards the energy suppliers' 2020 target.<sup>139</sup> It is unclear what will happen to households with a SMETS1.
- Consumer activation. The CMA's study of international experiences was unable to find evidence that SMs had increased the proportion of consumers who switched their supplier.<sup>140</sup>
- Exploitation of consumers by suppliers. At our events, we heard concerns that suppliers could use the additional information on consumer behaviour to identify consumers who are unlikely to switch and price discriminate against them. In respect to this, we note that consumers have the right to decide how SM information is used by suppliers and whether it can be shared.<sup>141</sup>
- Risk of further rationing. Regulators need to be aware that more information on costs may lead low-income consumers to further ration their consumption of energy.
- Opportunities will be greater for more affluent consumers. One of the great hopes is that data on half hourly usage will allow suppliers to offer bespoke deals and incentives for consumers to use energy at specific times of the day, with devices automatically linked to these commands. Given the costs of technology, it is likely that these opportunities will flow more to affluent than lower income consumers.

### Policy recommendations

- **Recommendation:** The Government should ensure that smart meters are taken up equally among low-income consumers as among the wider population. If necessary this will have to involve strict requirements that SMs are installed in a

cross-section of households rather than just offered. This could be added as an additional license requirement by Ofgem.<sup>142</sup>

- Recommendation: There is huge uncertainty over the benefits and disbenefits of SMs and who will gain and who will lose. In the longer-term, Ofgem will have to monitor the impact of the technology and consider carefully whether additional safeguards are needed to protect low-income consumers from being exploited.

## Demand side: Landlord behaviour

Our research found that tenants often stick with the existing payment methods and the suppliers that are in place when they move into a rented property. This contributes to lower switching rates and poorer deals. Landlords should be encouraged to prompt their tenants to switch. In addition, we heard anecdotal evidence of landlords insisting that specific providers supply energy.

### Private rented sector

Policymakers should consider encouraging landlords to nudge their tenants to switch energy suppliers. Given the comparative churn in the private rented sector, this would mean that consumers would have a regular prompt to switch each time they move home. This nudge could also be instituted at points of contract renewal which typically occur annually.

This policy could be pursued through hard regulation of tenancy agreements or through local authority licensing arrangements where they exist. Alternatively, trade bodies and professional associations – such as the National Landlords Association – that represent landlords could institute it as best practice in their professional standards.

- **Recommendation:** The Government should work with private landlord bodies to introduce prompts for tenants to engage with their energy supply.
- **Recommendation:** Local authorities should consider what actions they can take under their licensing regulations to prevent landlords from imposing restrictions on tenants choosing their energy supplier or payment method.

### Establishing incentives for social landlords to act as agents on behalf of tenants

Social landlords are playing increasingly important roles in the lives of their tenants, whether this is through employment and training, financial guidance or other forms. This is likely to increase further as Universal Credit is rolled out and housing benefit is paid via the tenant, because landlords will have a greater financial incentive to ensure that tenants can budget and afford to pay their rent payments. In many cases, social landlords are also trusted by tenants.

We heard an individual story where a landlord had intervened to help a tenant get on to a better energy deal. The social landlord in London had proactively encouraged the tenant to assess how his home could be made more energy efficient and to re-consider his energy tariff.

*Yes, I think now every year I will be going online and just ensuring that [X supplier] is still the best choice and, if I find one that's selling cheaper, I will give these guys a call and just quick check just to make sure you are doing the right thing. Man, Single, no children, London*

As well as now being on a better deal and having more efficient white goods, he is also aware of price comparison websites and how to use them and reported that he will look to use these tools again in the future to make sure he stays on a good deal.

- Recommendation: There would be benefits to encouraging experimentation to allow evaluations of whether one-off interventions or repeat interventions are needed to help move consumers onto better tariffs and whether this engagement is sustained into the longer-term. Social investors could establish a fund for social landlords to address this acting as a reward payment for them to help their tenants.

## Supply-side: Spreading the costs of digitally-excluded consumers

Effective markets send signals to consumers: not to over-consume and to adopt behaviours that enable efficient exchanges. In addressing the energy poverty premium, we should as far as possible retain rather than remove the incentives for consumers to control their energy consumption, and to make communications digital rather than paper-based. However, there may also be instances where incentives are no-longer effective.

For instance, it seems unlikely that many consumers would swap back to paper bills once they have switched to electronic communications. For these consumers, the incentive could be considered irrelevant. If this is the case, then the key question is whether we can expect the behaviours of those who have opted for paper-based communications to change in the future. Here, we may hypothesise that the effect of the financial incentive for such consumers to receive digital communications will yield diminishing returns. This is because such consumers can be expected to have increasingly strong reasons for requesting paper billing (e.g. digital exclusion) and therefore be very unlikely to alter their behaviour.

These hypotheses should be tested through behavioural science trials, with a view to altering the regulation on premiums for paper billing so that the costs of these marginal activities would be borne by all consumers. This policy could be developed as part of Ofgem's reforms to supply licence rules relating to customer communications.<sup>143</sup>

Alternatively, Ofgem could extend its principles-based regulation which it uses to influence suppliers' behaviour towards vulnerable consumers (see PSR License Conditions).<sup>144</sup> This could be done by stipulating that suppliers must offer the relevant discounts to vulnerable consumers unless there is a reasonable expectation that the consumer could change their behaviour. A further option worth exploring would be whether consumers could opt out of digital communication.

- **Recommendation: Ofgem should test whether the financial incentive for consumers to opt for digital billing is effective. In the long-term, Ofgem should look to spread the costs of paper billing across all consumers.**

## Intermediate markets: Designing payments for low-income consumers

Behavioural factors lead low-income consumers to prefer non-standard payment methods such as prepay and quarterly bills. Below we discuss some policies that could reduce the poverty premium in energy.

### Request to Pay

As the University of Bristol puts it, ‘direct debit discounts are an obvious way to create a poverty premium’.<sup>145</sup> Reforms to the payments system will mean Request to Pay (RTP) will replace direct debit (DD). Under RTP, the payer views the request for payment and then decides whether to approve it. RTP, therefore, provides greater flexibility over when payments are made and can help consumers retain control of their finances.

There are already RTP products such as Apply Pay and Paypal. However, the new payments system is moving to make an RTP method ubiquitous and available to all bill payers. Handing greater control to consumers should mean that a larger number are ready to use electronic payments rather than quarterly bills or PPMs.

- **Recommendation: In taking forward the new payments regime, we recommend that policymakers consider:**
  - The complexity and design of the payment product – concerns were raised in our discussion group that RTP could be too complex and rely on an excessive amount of communication.
  - Whether and how consumers will be able to set up weekly rather than monthly payments. Many households budget on a weekly timescale, and this would allow the payment structure to fit the patterns of how low-income households live rather than forcing them to conform to the pattern of higher-earning households.
  - Bringing the energy suppliers, the payments industry, banks and consumers together to discover solutions that work for all parties rather than assuming it to be a payments industry issue.
  - Analyse what proportion of low-income consumers are likely to take advantage of RTP.

### Pay as you go

There is no logical reason why, in the medium term, prepaying for energy should be more expensive than paying by normal billing. Few suppliers now charge for the removal of PPMs. Paying by debit rather than credit should cut the cost of capital and the risk of arrears. The technologies are available to significantly reduce the costs of processing payments that have historically made PPMs more expensive. For instance, consumers will be able to top up their accounts via their mobile phone and via plastic cards. Social enterprises are entering the market. SMARTprepay claims to be the ‘first system with the technology and sophistication to finally offer price parity between prepayment and credit customer’.<sup>146</sup> Smart meters will replace the physical PPM and therefore should eliminate the costs of installation and removal of PPMs.

While the issue of debt recovery will remain live, it is unclear why debt should be recovered as part of consuming energy rather than through a parallel transfer. Recovering debt through the bill increases the marginal cost of energy and makes it harder for the consumer to observe whether they are getting a good deal.

- **Recommendation:** The Government should take forward legislation to require Ofgem to move in the medium-term to force suppliers to offer the same deals to PPM consumers as they do to other consumers. This would force suppliers to innovate and to work with social enterprises, tech companies and fintech to reduce the remaining costs associated with PPMs. The legislation should set a target date for such a policy, e.g. 2023.

## Summary

This chapter has put forward a range of policy responses to address the poverty premium in energy. Table 5 summarises these policy steps, which aspects of the poverty premium they address, which underlying factors (if any) they address, the time horizons for their impact and governmental actors who would lead the reform.

**Table 5: List of measures and the aspects of the energy poverty premium that they address**

Type of intervention	Policy reform measure	Premium it addresses	Underlying factor(s) it addresses	Time horizons	Likely scale of impact	Actor
Subsidy	Warm Home Discount	All	None directly	Medium	Medium	BEIS
Supply-side	Public sector operator	All	Market competitiveness in sub-markets Complexity of products / information Cross-subsidy of others in the market	Medium	Small	Scottish Government, Welsh Assembly, Local government
Supply-side	Price cap measures	Not being on the best energy tariff	Cross-subsidy of others in the market Complexity of products / information	Short	Large	BEIS / Ofgem
Demand-side	Automatic collective switch	Not being on the best energy tariff Being on a tariff whose charge structure does not match your energy consumption	Less capacity for decision-making Limited access to enabling products Lower levels of literacy, and digital and financial literacy Behavioural traits Market competitiveness in sub-markets Cross-subsidy of others in the market	Medium	Large	BEIS / Ofgem
Demand-side	Smart Meter roll-out	Being on a pre-payment meter Not paying by direct debit	Cost-reflective premiums Market competitiveness in sub-markets Complexity of products / information Behavioural traits	Long	Medium	BEIS / Ofgem / Smart Energy UK
Demand-side	Landlord regulation	Tariff premium Product suitability	Behavioural traits Constraints on choice due to housing circumstances	Medium	Small	BEIS / DCLG / Scottish Government / Welsh Assembly
Demand-side	Social landlords support	All	Constraints on choice due to housing circumstances	Short	Small	DCLG, Scottish Government, Welsh Assembly, Local government
Financial services	Request to Pay design	Not paying by direct debit Being on a pre-payment meter	Behavioural traits	Medium	Small	FCA / Ofgem / Payments System Operator
Supply-side	Prepayment meter requirement	Being on a pre-payment meter	Cost-reflective premiums	Medium	Medium	Ofgem
Supply-side	Spreading costs of digital exclusion	Paper billing Not paying by direct debit	Cost-reflective premiums	Medium	Small	Ofgem

## Conclusions

This report has examined how consumers experience the energy poverty premium and why. Just as the problem is multi-faceted, so our solutions are multiple.

We conclude that policymakers and regulators must understand the underlying factors that drive behaviours among low-income consumers to intervene effectively.

As Table 5 indicates, the report proposes policies across a range of areas. Of the interventions discussed, we conclude that the policy of auto-switching consumers could be the most transformative in the long-term. This is because it seeks to maximise the benefits of competition whilst ensuring that consumers who have typically missed out from the best deals would be able to obtain them. In contrast, the energy price cap reduces the energy poverty premium but at the expense of competition. We propose that the policy of automatic switching could be phased in as the price cap is removed, and would require significant infrastructure and set-up time. This could be powerful politically as well as in practical terms.

Notwithstanding this, it is likely that a wide range of other interventions will be needed to help address the poverty premium, including reforming the Warm Home Discount, incentivising suppliers to reduce the costs to prepayment meter consumers and ensuring that third parties, such as landlords, can play a constructive role.

## ANNEX 1: OTHER POLICIES CONSIDERED

In addition to the policies presented in this report, a range of other prospective policy measures were considered in our discussions with stakeholders. We give a brief overview of these below, as well as our rationale for not including these policies within our main analysis.

### **Improving information for consumers**

We discussed the role that improved information provision could play in eliminating the poverty premium in energy. This included:

- Regulators providing consumers with better information
- Kitemarking products or providers – for example, a kitemark for energy companies that offer a “fair deal” for consumers.
- Social norm messaging.
- Improving transparency of pricing and price differentials between suppliers.

While we can see the arguments for policy interventions in all these areas, we have not focused on such information-related interventions. This is because much of the recent focus on improving outcomes in the energy market has been on better information provision, and increasing awareness of the benefits of switching. Information on the benefits of energy switching is now available from a wide number of sources including local government, energy companies, price comparison websites, regulators and charities. The persistence of an energy poverty premium despite efforts to increase information availability suggested, to us, that we should focus our policy analysis on other areas.

### **Increasing the ease of switching provider**

As well as improving information availability, we discussed the case for making it easier to switch energy providers – for example by reducing the time taken to switch from one provider to another. However, as with information provision, much of the policy focus in recent years has been on encouraging individuals to switch provider and improving ease of switching, yet an energy poverty premium persists despite this. This did not come up as an important dimension in our fieldwork.

### **Applying social pressure on suppliers**

We discussed the role that social pressure could play in encouraging energy providers to offer a better deal to lower income households. Our view was that such social pressures are already applied to a significant extent – by politicians, charities, regulators and the media. Past SMF work has proposed steps to improve how this pressure is exerted.<sup>147</sup> However, we believe this is more likely to affect the experiences of the general consumer rather than those experiencing the poverty premium.

### **Community or household generation schemes**

We discussed the role that community or household generation schemes could play in reducing the energy poverty premium – for example, through the installation of solar panels and wind turbines on homes or community schemes.

We have not considered such policies in our report, because the issue requires very detailed analysis before its potential merits can be assessed. Establishing the economic case for such “self-generation” schemes would require detailed analysis of the costs of installation, the appropriate funding model for such a scheme, and the amount of energy that could reasonably be expected to be generated. Given the involved nature of this exercise, and the need for expert insights from the energy industry, we have not examined this policy in the report; we are not in a position to quantify the costs and benefits of such a scheme. It is an area worthy of further analysis.

### **Pro-competition measures: splitting up large providers**

We discussed the potential for splitting up some of the larger energy providers to increase competition in the energy market. However, it was unclear that increased competition across the whole market would eliminate the price premium paid by many low-income households – particularly if they are less likely to switch provider. We note also the persistence of the poverty premium notwithstanding the significant growth of suppliers in the market.

### **Universal Service Obligations (USOs)**

We considered the role that new USOs could play in reducing the energy poverty premium. However, we felt that such a policy intervention has been subsumed by the energy price cap, which we discuss in the report.

### **Better data sharing on consumers affected by the poverty premium**

The role of data sharing between regulators in eliminating the energy poverty premium was considered. We felt that the principal problem currently is the inability to identify consumers who experience the poverty premium and that this should be the priority. Data sharing is likely to be very important in addressing the wider poverty premium across different markets and facilitating coordinated action from regulators. This is worthy of further analysis.

### **Jam jar accounts**

“Jam jar” bank accounts, which allow individuals to divide their money into separate pots for different expenses, were considered as a means of reducing the energy poverty premium, by giving consumers greater confidence to pay bills by direct debit. However, we felt that the benefits from such an approach are likely to be limited given the existing problems around take-up and the costs of providing the service.<sup>148</sup>

From a financial services perspective, we felt that Request to Pay held more promise in terms of its ability to address the poverty premium.

### **Digital access and education**

We discussed the role of digital access and digital education in reducing the energy poverty premium. Arguably, improving digital skills could lead to higher rates of energy switching as more individuals are able to research on the internet and use tools such as price comparison websites. Likewise, access to digital services could allow a wider number of people to use online tools to get the best deals and avoid paper billing.

We felt that these agendas are very broad and better discussed elsewhere. Further focused work is needed.

### **Subsidies to enable investments for households off grid – for example, connecting individuals to the gas network**

As with self-generation schemes, we believe that this is a policy worthy of exploration, though assessing the costs and benefits of investment in gas connection would be a detailed exercise. It is possible that the overall economic costs of connecting individuals to the gas network would exceed the benefits, and there are significant question marks over who should and would bear the costs of such a policy intervention. Given the uncertainties and our inability to gauge the costs and benefits of such a policy intervention, we have not considered it here. It should be noted that there are already schemes underway to promote access to the gas grid especially for those at risk of fuel poverty.<sup>149</sup>

### **Reforming the Winter Fuel Payment**

We concluded that the Warm Home Discount (WHD) is qualitatively different from the Winter Fuel Payment (WFP). First, in contrast to the former, the latter has already received significant policy and political attention with the Conservative Government deciding in summer 2017 to retain the policy as it is. Second, the WFP is based in part on the assumption that older people spend more time at home and having higher heating needs than younger people. Other questions of intergenerational fairness are beyond the scope of this report: the government could decide to remove the policy or means-test it, just as it could decide to abolish the triple lock on pensions or increase the rate at which working-age benefits are updated.

## ANNEX 2: QUALITATIVE RESEARCH

We conducted 20 depth interviews with low-income consumers. The research participants were recruited by Indiefield. Our selection criteria included minimum quotes on gender, employment status, age, country of birth, being on a SVT, being on a prepayment meter, receiving paper billing, paying bills in arrears, and household composition. Twelve interviews were carried out in London (at the SMF offices) and eight in Birmingham (at the homes of the respondents).

The interviews lasted between 45 minutes and an hour. Participants were asked questions prepared in an interview guide.

Eight of the participants from London subsequently attended a focus group discussion in London held at the SMF offices.

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