Response to Ofgem's call for evidence on levelisation of payment method cost differentials

May 2023

About Fair By Design

Fair By Design is dedicated to reshaping essential services such as energy, credit, insurance and payments so that they don't cost more if you're poor – also known as the poverty premium. Fair By Design collaborates with regulators, government and industry to design out the poverty premium. Our Venture Fund provides capital/funding to grow new scalable ventures to innovate the market and design out the poverty premium. Ascension manages the Fair By Design Fund. Fair By Design is managed by the Barrow Cadbury Trust on behalf of a group of foundations.

In the context of the energy market, we believe that households on low incomes/living in poverty should not incur a poverty premium based on the way they pay for their energy.

Please note that we consent to public disclosure of this response.

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Summary

We are grateful to Ofgem for the opportunity to submit evidence on a subject that is core to our mission and for the context that Ofgem has set out and the helpful analysis of the different options.

We centre those with lived experience in our work. In order to respond to this call for evidence, we held two focus groups with people on low incomes, one online on the 25th April with 11 participants, and one in person in Glasgow on the 27th April with 13 participants, facilitated by Poverty Alliance, to seek views on how people feel about the way they pay for their energy. This response aims to represent those views.

Our starting point is that people on low incomes should never pay more for an essential service because of the way they pay. We therefore welcome the Government's recent announcement to end the prepayment meter premium, and Ofgem's current work to look at how this should be implemented on a permanent basis. As Ofgem's call for evidence explains, a higher proportion of people paying for their energy using a prepayment meter are fuel poor and/or vulnerable according to the most recent fuel poverty statistics (around 27-28%). This is also true for standard credit (around 17-18%), although we are conscious that the size of the standard credit premium (£202

under the current price cap[1]) compared to that for prepayment meters (£45), means that levelising tariffs will have a significant impact on those on low incomes paying by other means, primarily direct debit.

Nonetheless our view is that full levelisation is the right way forward. This is based on some clear themes emerging from the recent focus groups we ran with Poverty Alliance; namely that the current system is too complicated and, given recent events in energy markets, goodwill to trust that these complicated tariffs are correct is in short supply. Current tariffs often penalise those who have chosen a payment method to take back much-needed control from a system they don't trust. Participants in the focus groups had some pertinent questions of their own:

"Why am I being charged more just because of the way I pay?"

"Why do I pay more when I am paying in advance?"

"Why does an energy supplier get to keep hold of my money without giving me any interest?"

"If I pay on time why should I be penalised?"

"Why do I have to pay a standing charge even when I am not using any energy?"

Those who took part in our focus groups were happy to pay a fair price for their energy. But they also felt that energy should be affordable and that the way tariffs are calculated should be clear and transparent. **We therefore favour full levelisation combined with the introduction of a social tariff (we are aware that a social tariff is beyond the scope of this call for evidence). We advocate the removal of standing charges for those on low incomes as part of a social tariff.**

Question 1: What do you think the objectives of levelisation should be (eg, full levelisation across payment methods, partial levelisation, anything else)?

We would like to see full levelisation across payment methods. The majority of people in our focus groups felt that any extra costs associated with standard credit or any other method of payment should be spread across all consumers. Two participants disagreed and felt that extra costs should be shouldered by the consumer paying by that method of payment but the extra cost should be transparent so that the consumer could make an informed choice about whether they wished to continue using that particular method of payment. There was some awareness that prepayment meter customers paid more for their energy but no awareness (expressed) within the two groups of the standard credit premium and many people were genuinely shocked by the size of the latter.

It is important that there is broad public support for the way that energy is regulated. Whilst some people are prepared to accept small variations in tariffs and trust that these have been calculated fairly, significant premiums require transparency and public acceptance that they are fair. It is not clear to us that there is this widespread understanding and that acceptance exists, nor that the

[1] https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-april-2023-30-june-2023

public is happy to leave this to the regulator to get right. We therefore believe that Option 3 (full levelisation) is the best option.

We note that differences between smart meter and non-smart meters and regional differences are out of scope of this call for input. Nevertheless, we would like to see Ofgem applying the same rationale when considering these differentials too. In other words, Ofgem should consider whether consumers, and particularly vulnerable consumers, can reasonably be expected to be aware of a price differential and whether they are able to, or likely to, change their behaviour in response to a price signal.

Question 2: Should we only focus on PPM levelisation or should we also consider SC?

Standard credit should also be considered. Participants in our focus groups who paid by standard credit did so due to lack of trust in energy suppliers. For example, one participant changed to standard credit from direct debit around six months ago because he did not trust the energy company having his bank details and had heard stories of energy companies increasing direct debits without even asking people. People were not generally aware that they paid more overall for their energy by paying this way.

Anecdotal evidence from other sources suggests that the sharp increase in energy bills over the past couple of years has led to concern that they are paying the right amount and that changing to standard credit gives people a feeling of control over this.

Question 3: If SC is included in levelisation, should some degree of price difference remain, whereby SC is higher than DD to maintain an incentive for customers to go on DD?

For such an incentive to work, consumers need to be aware of the premium incurred. A recent survey by Octopus[2] showed that 75% of those surveyed were not aware they were paying a premium for paying by standard credit. In addition, the standard credit premium has nearly tripled since 2021 so even a consumer who was aware of the premium may well not be aware of the scale of the increase. The fact that the premium has increased significantly has occurred at the same time as an increase in people turning to standard credit, after a long-term trend of decline in the number of people paying by this method[3], supports the hypothesis that either people are not aware of the premium or that the premium is not affecting their choice of payment method.

If any premium were to remain, consumers need to be made aware of this so that they can make an informed choice. However, our preferred option is full levelisation.

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[2] https://octopus.energy/press/octopus-energy-calls-on-ofgem-to-clamp-down-on-payment-penalty-for-careful-customers/

[3] Fuel poverty statistics 2022 - GOV.UK (www.gov.uk)

Question 4: After considering the different levelisation options presented (charge type, individual elements of the price cap, extent to which levelisation should occur), are there any further levelisation options that you think should be considered?

No.

Question 5: Can you provide any evidence on why one levelisation option should be preferred over another?

As explained in response to Q1, our focus groups confirmed the findings of the recent Octopus research showing that the majority of people are not aware that these differences in tariffs for different payment methods exist. When the existence of these differentials and the reasoning behind them is explained, most people we spoke to did not feel that they are fair and reasonable, particularly when they are large (ie over £200 for paying on receipt of bill).

In addition, our Participatory Action Research (conducted with Ofgem and Toynbee Hall)[4] on the transition to net zero identified that standing charges were viewed as unfair by low-income participants because low-income households use less energy on average but everyone is charged the same flat rate for the standing charge.

Question 6: Can you provide any evidence of levelisation effects that should be avoided that have not been shown within our analysis?

No.

Question 7: What are your views on targeting levelisation to particular groups of customers within payment methods (eg customers under the price cap or in vulnerable situations)? Do you have evidence to support your views?

In principle, we would be open to the idea of targeting additional support to those in greatest need. However, in practice, Ofgem has no means of identifying or targeting low-income consumers . Therefore, in our view, Ofgem should level the playing field in terms of payment method cost differentials and the social tariff should then be targeted at low-income households to ensure that energy is affordable for all.

Question 8: Given the distributional impacts analysis provided above, what is your view on the benefits to consumers on the levelisation of payment methods?

[4] https://www.toynbeehall.org.uk/wp-content/uploads/2022/09/Toynbee-Hall_Net_Zero_Report_29_09_2022.pdf

We recognise that full levelistion (Option 3) will mean that the gains from levelising for PPM are cancelled out by spreading SC costs across PPM and DD customers. Nonetheless, people on low incomes told us that they wanted to see more equitable treatment of consumers. We also believe that this change needs to be closely coordinated with the introduction of a social tariff targeted at those on low incomes to cushion the impact of this change.

Participants in our focus groups found it particularly troubling that under the current price cap, someone who wanted to pay by standard credit due to lack of confidence in their energy supplier would still face a significant “standard credit premium” even if they paid their bill on time.

Question 9: Do you agree with our characterisation of the effects on competition? Can you explain why or why not?

n/a

Question 10: Are there any additional impacts on competition or other areas that we should consider? Can you provide evidence of these?

n/a

Question 11: Do you agree with our assessment on market competition and incentives? Can you explain why or why not?

As stated in response to Q3, we do not agree with the unevidenced assumption that reducing payment method differentials reduces the incentives on suppliers to move consumers to more cost-efficient payment methods and reduces the incentives on consumers to switch payment methods. The evidence suggests that most consumers are not aware of the price differential between payment methods and therefore the differential will not have any impact on their behaviour. In addition, the huge increase in the standard credit price differential that we have seen over the past two years has not resulted in more people switching from standard credit to direct debit, in fact the opposite has occurred.

Our focus group evidence suggests that trust in energy suppliers to set direct debits at an appropriate level and not keep hold of consumers’ excess credit is one of the causes of the recent increase in consumers paying by standard credit.

Question 12: Are there any other impacts on your organisation or the market that we have not considered?

n/a

Question 13: If costs are not reconciled, what would the impact of payment method levelisation be on your organisation, where relevant?

n/a

Question 14: Do you consider that the costs of levelisation should be reconciled between suppliers? What are your views on the reconciliation mechanisms presented?

Any reconciliation mechanism will need to be fair to suppliers whilst maintaining the incentive on suppliers to engage in a constructive way with their customers to reduce and manage debt.

Question 15: Are there any other reconciliation mechanisms that you think we should consider that we have not discussed?

n/a

Question 16: Is there anything else Ofgem should consider with regards to levelising costs across payment methods?

We would like to see Ofgem exploring the potential of different methods of payments which could address some of the concerns of energy consumers and also decrease costs for suppliers. For example, variable direct debits, which are already used by some suppliers, could give consumers some of the benefits of standard credit in terms of greater control through only paying what they owe, but at a reduced cost to suppliers given the greater commitment to pay from the consumer from direct debit. In addition, mechanisms such as "Request to Pay" would enable consumers to spread the costs of their energy bill over the month. Participants in our focus group felt this would be helpful to certain households where, for example payment of benefits did not match with the monthly direct debit schedule, and/or where one person in the household was paid monthly and another person was not.