Response to Ofgem's consultation on levelling the cost of standing charges on prepayment meters

14th September 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

In July 2023, the Government brought in temporary measures to end the premium pre-payment meter (PPM) customers paid for their energy, whilst tasking Ofgem with finding a way of ending the PPM premium permanently when the Energy Price Guarantee comes to an end in April 2024. Ofgem has taken the opportunity to look at the premium paid by customers who pay on receipt of bill (known as standard credit (SC)) as well as the premium paid by PPM customers. Building on the call for input earlier this year, this consultation sets out Ofgem's preferred option and two other options:

Option 1: Do nothing;

Option 2 (preferred by Ofgem)**:** Levelise pre-payment meter (PPM) and direct debit (DD) standing charges and levelise Additional Support Credit (ASC) bad debt costs across all payment method standing charges supported by a reconciliation mechanism; and

Option 3: Option 2 plus levelise debt-related costs.

Fair By Design's preferred option is **Option 3**. Although Option 3 benefits standard credit (SC) customers at the expense of pre-payment meter (PPM) customers, we believe that levelising debt related costs is the fair thing to do. Under Option 3, PPM customers are still better off compared to the base case of doing nothing (Option 1), and SC customers have their premium reduced from £129 to £85 compared to paying by DD.

Our preferred option in Ofgem's call for evidence[1] on levelisation of payment method cost differentials was for full levelisation of all payment methods. This was based on some clear themes emerging from the focus groups we ran with Poverty Alliance in April 2023 (referred to as "focus groups, April 2023" throughout this report); 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, often whilst being unaware that they are choosing a more expensive way to pay.

However, in order to counteract the increase to PPM charges that full levelisation would cause, we felt this needed to be closely co-ordinated with the introduction of an energy social tariff. Unfortunately, the Government has not to date issued a consultation on price support as promised and we acknowledge that general affordability issues are a matter for Government.

We would like to see Ofgem encouraging suppliers to offer a greater range of payment methods, in order for consumers to budget and control payment in a way that suits them. This would be a win for suppliers too as it should lead to a reduction in debt. However, consumers have told us that they do not want further complication and variation in the way they are charged for their energy. Therefore, levelisation of payment method cost differentials needs to be an ongoing conversation as the range of payment methods expands, and proposals on locational and temporal pricing come under consideration.

Question 1: Do you have any views on our proposed case for the introduction of levelisation of payment methods?

Fair By Design largely agrees with the case for change set out by Ofgem in Chapter 2. We agree that Ofgem's principle objective, to protect the interests of energy consumers, including vulnerable consumers (such as those on low incomes amongst others), requires looking at levelisation of charges for different payment methods. We note that adherence to a cost-reflective approach has resulted in the unintended consequence of higher standing charges for pre-payment meter (PPM) customers compared to equivalent direct debit (DD) customers and that PPM meter customers are more likely to be low users of energy and on

[1] Ofgem (2023), Levelisation of payment method cost differentials: a call for evidence. https://www.ofgem.gov.uk/publications/levelisation-payment-method-cost-differentials-call-evidence

a low income. We also agree with a market-wide design approach as opposed to only looking at consumers affected by the price cap to ensure all consumers are treated fairly.

We welcome the research Ofgem has conducted into consumer vulnerability[2] which demonstrates the lack of awareness amongst consumers that charges vary for different payment methods and that there are geographical differences in what households pay for their energy. We believe that Ofgem's duty to have regard to "the principles under which regulatory activities should be *transparent, accountable*, proportionate, consistent and targeted" is relevant here.

We would have liked to have seen more exploration in the case for change of the reasons for looking at sharing specific debt-related costs (part of Option 3) in the context of "fair prices". It seems to us inherently unfair that Ofgem identifies which households are likely to incur more debt and places more costs on them as a group, including on individuals who pay their bill on time. This is a key reason for our preference for Option 3.

Question 2: Do you have any views on our proposed policy considerations for levelisation? Are there any additional ones we should consider?

We agree that the levelisation process would need to be designed on an enduring basis and that levelisation should be applied to cap and non-cap tariffs.

We agree that due to the usage characteristics of the different payment methods and inability for some customers to choose a payment method, PPM standing charges should be equal to or less than DD and that standing charges are the priority to address. Our Participatory Action Research (conducted with Ofgem and Toynbee Hall) on the transition to net zero[3] 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.

However, the Government's clearly stated intention was to get rid of the PPM premium altogether. Therefore, the policy intent needs to go beyond standing charges to cover PPM unit rate charges as well. We would like to see a clear commitment from Ofgem to the permanent abolition of the PPM premium. Consequently, if any future policy changes result in the PPM unit rate going above the DD unit rate (assuming that standing charges are levelised), then changes to the levelisation mechanism should be consulted on at the same

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[2] Ofgem (2023), Consumer Impacts of Market Conditions survey - Wave 3: https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022

[3] Net Zero Transition for Low-income Consumers: A Participatory Action Research Project A Toynbee Hall report in partnership with Fair by Design and Ofgem. (2022). Available at: https://www.toynbeehall.org.uk/wp-content/uploads/2022/09/Toynbee-Hall_Net_Zero_Report_29_09_2022.pdf [Accessed 1 Sep. 2023]

time as consulting on any changes that result in the PPM unit rate exceeding the DD unit rate.

We agree that Ofgem should consider whether to allocate debt costs more broadly within payment methods.

We agree that to ensure that suppliers are incentivised to offer services to customers on all payment methods, they should expect to be able to recover notionally efficient costs irrespective of the proportion of customers they have on each payment method.

And finally, we agree that the process will need to be designed to be agile as long as it is clear that the overall intention is to get rid of "poverty premiums" in other words additional costs incurred by pre-dominantly low-income consumers.

Although not mentioned in this section, we also welcome the proposal that the PPM standing charge will not be increased to match the DD standing charge if it is already lower.

We would like to see a broader policy intention to encourage, maintain and expand a broad range of choice of payment methods for consumers within the energy market. This ranges from keeping open the option of being able to pay quarterly on receipt of bill, to being able to use Request to Pay or flexible direct debits. However, Ofgem's own consumer research[4] backs up our own findings (focus groups, April 2023) that consumers are already bewildered by the complexity of tariffs and that Ofgem's duty to have regard to transparency and accountability points to the need for greater simplicity in tariffs at the same time as expanding choice of payment methods. Greater flexibility may well help suppliers encourage some people onto DD and away from SC, reducing costs overall.

Question 3: Do you agree with our initial preference to levelise PPM and DD Standing Charges?

No. We want to see premiums for different payment methods abolished or at least reduced as far as possible and therefore our preference out of the options consulted on is Option 3.

Question 4: Do you think we should also levelise the bad debt charges across PPM, DD and SC, which would reduce the differential between SC and DD? Please provide any evidence /data that may benefit consumers as a whole.

Yes. Levelising bad debt charges across all consumers seems to us, to be the fair thing to do and in line with what people on low incomes have told us they feel is fair. It is not clear to us why bad debt costs should be placed on a particular group of consumers just because people who use that method of payment are more likely to run up debt.

[4] Ofgem (2023), Consumer Impacts of Market Conditions survey - Wave 3: https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022

In addition, we welcome the reduction of the standard credit (SC) premium. Option 2 would leave a standard credit premium of £129. This is a substantial premium compared to the PPM premium of £26 shown in Option 1 – the base case of doing nothing. As Ofgem's own research shows, 48% of those paying by standard credit are in receipt of Government benefits, which is a significantly higher proportion than the 31% who receive benefits and pay by DD. We recognise that this is not straightforward as this represents a transfer from a slightly more vulnerable group (those who pay by PPM) to a slightly less vulnerable group (those who pay by SC). Nevertheless, even with Option 3, SC customers are left paying a premium of £85 which we continue to be concerned about given that both Ofgem's consumer research[5] and our own research (focus groups, April 2023) suggest that people choose this method of payment to be in control, sometimes due to lack of trust in suppliers, and that only just over half (55%)[6] are aware that there is a premium for paying this way.

Question 5: How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (ie uncapped)?

n/a

Question 6: Do you agree with our proposal not to levelise across regions?

Given the need to implement this change by April 2024, we agree that the issue of levelisation across regions should be postponed for the moment. However, we are concerned about the gap between consumer understanding and reality on this issue which calls into question whether aspects of Ofgem's retail regulation are "transparent" and "accountable". In Ofgem's consumer research[7] less than half (42%) of participants correctly identified that the cost of energy varies depending on what region you live in.

As stated in our response to the call for evidence we believe that when considering whether a price differential is fair, 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.

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[5] Ofgem (2023), Consumer Impacts of Market Conditions survey - Wave 3: https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022

[6] As above

[7] Ofgem (2023), Consumer Impacts of Market Conditions survey - Wave 3: https://www.ofgem.gov.uk/publications/consumer-impacts-market-conditions-survey-wave-3-novdec-2022

We look forward to seeing this addressed as part of consideration of locational pricing in due course.

Question 7: Do you agree with our proposal not to target levelisation?

As stated in our response to the call for evidence, in principle we are keen to see support targeted at those who need it most. However, in practice, Ofgem has no means of identifying or targeting low-income consumers. We welcome Ofgem's public calls for the Government to look seriously at options for long-term price support, including a social tariff for energy.

Question 8: Should we set new licence conditions to ensure suppliers pass the costs/benefits through to all customers?

Yes.

Question 9: Do you have any views on our other considerations?

We are concerned that the opportunity to be more ambitious in terms of getting rid of the standard credit premium has been missed, partly (we recognise there are other considerations too) due to more emphasis being placed on economic theory as opposed to real world evidence about how people behave and why.

In Chapter 3 (pg 28), Ofgem argues that it is not considering levelising SC standing charges due to the risk that fully removing the SC and DD differential would remove the financial incentive for customers to stay on or move to DD. We accept that this is a theoretical risk. However, we note that Ofgem's Impact Assessment concludes that switching is relatively inelastic and that "levelisation is unlikely to drive material volumes of switching between different tariff types" (Appendix 2, p84). We also know that the standard credit premium has nearly tripled since 2021 and yet at the same time there has been an increase in people turning to standard credit, after a long-term trend of decline in the number of people paying by this method[8], contrary to what economic theory would predict. The fact that there is a significant lack of awareness of the standard credit premium, and that people prioritise other reasons over cost when choosing payment method are likely to be contributing factors. However, Ofgem continue to place significant emphasis on what they expect to happen despite this prediction having very little grounding in reality.

Although our evidence is not representative, our focus group findings suggest that low-income people would favour more equitable outcomes and greater simplicity than the solutions consulted on here. We would like to see Ofgem building on the work that it has done with ourselves and Toynbee Hall working with those who have lived experience, in

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

developing their policy positions, in order to increase its accountability and to ensure that the right options are put forward for consultation.