



Campaigning for Warm Homes

Consultation Document Response

Energy Supply Markets Probe

Source: Ofgem

1. Introduction

1.1 National Energy Action (NEA) is a national charity working to reduce and, ultimately, eradicate fuel poverty. NEA seeks to achieve these objectives through policy development and representations to key agencies, Government, energy suppliers and the Regulator. NEA also has a campaigning role in pressing for programmes and resources to meet the needs of vulnerable energy consumers.

1.2 Whilst NEA sees poor energy efficiency standards as the major factor in fuel poverty and, consequently, heating and insulation improvements as the most rational and sustainable solution to the problem, we recognise the importance of low household income and unaffordable energy prices in sustaining and exacerbating fuel poverty. Therefore, NEA welcomes Ofgem's Call for Evidence on the working of energy supply markets as a means of redressing some of the failings of the market as it affects low-income energy consumers.

1.3 NEA's comments will be restricted to those areas of most concern to disadvantaged energy consumers and what we perceive to be market failure in providing for these customers. NEA's comments can be subsumed under the theme of the customer's perspective and experience of the market.

2. The customer's perspective and experience of the market

2.1 Clearly generalisations about customer experience are of limited value. Despite Ofgem's insistence that issues other than fiscal benefit are significant in switching/non-switching decisions NEA sees the market as driven by economics

and, consequently, will concentrate on this aspect. NEA recognises that the market has brought economic benefits to the majority of customers who have switched supplier and that innovation in tariff offers, for example on-line direct debit payment, have brought additional benefits to more affluent and confident customers. However there are a number of particular concerns relating to market operation as it affects disadvantaged and vulnerable customers; there are also issues around the extent to which Ofgem has distanced itself from the need to address these issues.

3. Incumbent suppliers and cost-reflective pricing

3.1 The domestic energy market remains a strange hybrid of laissez-faire economics and regulatory intervention. This is clearly demonstrated in the Ofgem review of disparities in charges imposed on prepayment customers where both Government and the Regulator have been minded to act to identify the extent to which 'unfairness' is a factor in prepayment charges. Since the stock response to perceived unfairness has been to emphasise market solutions i.e. the consumer can switch to a different supplier and/or a different payment method this represents an interesting development; it implies endorsement of cost-reflective pricing but willingness to act where there is evidence that charges are excessive.

3.2 In NEA's view one of the most stark anomalies in a supposedly 'fair' market is the way in which those consumers who are still served by their original supplier(s) are disproportionately disadvantaged. Ofgem continues to exhort these consumers to switch supplier in response to rising energy prices arguing that they stand to make the highest gains from doing so; but the Regulator is not minded to investigate the inherent unfairness that makes switching so worthwhile – the unjustifiably high premium charges levied on many consumers remaining with the 'incumbent' supplier.

3.3 In its evidence to the BERR Select Committee Inquiry into the Structure of the Energy Market, NEA noted that competition had existed since the late 1990s but that some 50% of customers had never switched supplier. In a properly functioning market the 'incumbent' would compete to retain these customers rather than relying on a mixture of lack of knowledge, anxiety about the process or misplaced loyalty to secure their custom. It should be noted that whereas suppliers of most goods and services might be expected to offer preferential terms to 'loyal' customers most energy suppliers adopt an opposite approach.

This issue is of particular concern given that the most economically disadvantaged households, Social Groups D and E, have the lowest rates of switching. Whilst around 50% of AB consumers have switched supplier only 36% of DE households have done so¹.

3.4 It should also be noted that there is a growing interest in the relationship between incumbent supplier, market distortion and customers. A recent national Audit Office report² commented: *'Some consumers, particularly those classified as vulnerable, are still unable to take full advantage of the competitive market for a variety of reasons, including complex tariffs and a lack of easily accessible, trustworthy, relevant, understandable and comparable information. In addition, the former incumbents (suppliers that in the past had monopolies) continue to have a strong position in their original markets. There remains a need, therefore, for regulators to continue to use their competition and consumer protection powers to ensure that markets continue to protect the consumer and that consumers can take further advantage of competition.'* The report also observes that: *'Competition has developed in all three areas but the former incumbents in energy still have large market share, and in the energy sector the incumbents are also able to price above the best alternative provider.'*

3.5 In fact the main issue is not the capacity of incumbent suppliers to price above the best alternative provider, rather it is the common practice of pricing above all of the main competitors. The National Audit Office has identified a real problem but proposes only a partial solution. The only way in which customers of incumbents can be fully protected is to end the iniquitous practice of charging them more.

3.6 This ostensible market failure has been discussed in a number of academic papers reporting findings from work undertaken at the Centre for Competition Policy³ which counsels: *'...there is also evidence that incumbents consistently charge more than entrants in these markets, which indicates some continuing market power of incumbents, particularly over consumers who are reluctant to switch supplier. We suggest that the markets are effectively bifurcated, with*

¹ Switching Rates for Vulnerable Customers: Summary Report, Ipsos MORI, March 2008.

² Protecting consumers? Removing price controls, Report by the Comptroller and Auditor General, HC 342 Session 2007-2008, 28 March 2008.

³ Social obligations and economic regulation, Professor Catherine Waddams, Centre for Competition Policy, 2004.

some consumers resistant to switching, so the incumbent mark-up indicates exploitation of market power for these non-switchers.'

4. Switching to disadvantage

4.1 Research into the competitive energy market has also revealed the extraordinary phenomenon of households having switched to a new supplier on terms and conditions that were disadvantageous⁴. Whilst it is difficult to see what measures might resolve this problem in such a diverse market and with so many variables, this should be a matter of genuine concern for Ofgem. Disappointingly the research found that only some 8-19% of switchers chose the most advantageous option in economic terms; rather worse were the findings that 20-32% of customers switched to an arrangement that was more expensive. The research notes that consumer detriment was of the order of £14 to £35 per year and whilst these sums may be considered modest they should be understood in the context of customers whose primary objective was to reduce energy expenditure and who were unable to cope with: *'complexities in the market [which] create consumer detriment and prevent the market from working well.'*

4.2 Disadvantaged households encounter sufficient difficulty in meeting utility costs without the prospect that their choices might further disadvantage them economically. If Ofgem is to continue to promote switching and competition as potential contributors in fuel poverty reduction it should look at the advice and guidance available to vulnerable households. Ongoing research⁵ by NEA indicates that disadvantaged consumers require considerable support in determining to switch in the first instance and, subsequently, in making the optimal choice. This support is best provided by a well-informed, trusted and impartial agency during a face-to-face consultation.

5. Prepayment meters

5.1 As briefly discussed at 3.1, NEA sees a willingness on the part of Ofgem and the Government to investigate prepayment charges as a significant step forward. For too long both parties have defended inaction on the grounds that some prepayment meter users were neither vulnerable nor disadvantaged and that any surcharge simply reflected additional costs involved in supplying these customers

⁴ Do Consumers Switch to the Best Supplier?, Centre for Competition Policy, CCP Policy Briefing, April 2007.

⁵ Tariff and Supplier Switching amongst Vulnerable Consumers: Interim Report, NEA, April 2008.

and maintaining the prepayment meter infrastructure. The continued depiction of prepayment meter use as a lifestyle choice seems absurd at a time when more than 70% of prepayment meters are being installed to recover debt⁶.

5.2 The Chancellor's Budget Report 2008 demonstrated new thinking on this issue: *'Customers using prepayment meters typically pay around £55 more on their energy bill compared to standard credit, and £144 compared to direct debit. These differentials have increased since the Energy White Paper. It is not clear whether these simply reflect extra costs to the energy companies nor whether prepayment customers are being given enough information on the availability of other tariffs. The Government believes that the time is now right to tackle this issue and is looking to Ofgem and the suppliers to bring forward proposals for treating prepayment meter customers more fairly. However, if sufficient progress is not made by next winter, the Secretary of State for Business, Enterprise and Regulatory Reform is prepared to use his statutory powers with a view to reducing the differential between prepayment and other forms of payment.'*

5.3 There is a degree of confusion in the Government position. It is recognised that there is unfairness in the treatment of prepayment users; that remedial action should be taken; and that energy suppliers should address these equity issues within a predetermined timescale (winter 2008-2009) in order to avert legislative intervention. This, however, is undermined by the suggestion that increased prepayment differentials may be justified in terms of cost-reflective pricing. It is difficult to reconcile these positions and NEA would suggest that Ofgem undertake a rigorous analysis of the case for any surcharge on prepayment and any justification for growing differentials relating to this payment method. Whilst it is conceivable that the 'additional cost to serve' is a factor in prepayment surcharges, previous Ofgem analysis⁷ suggests that the legitimate differential between prepayment and direct debit is in the region of £85 (as opposed to the £144 cited by the Chancellor in the 2008 Budget Statement).

5.4 Having identified prepayment surcharges as a key aspect of fuel poverty policy it is astonishing that the target date for investigation and remedial action should be so distant. The UK Fuel Poverty Strategy⁸ discussed this issue and concluded: *'the Government is concerned to ensure social equity in the share of*

⁶ Monitoring company performance – quarterly reporting, July-September 2007, Ofgem.

⁷ Domestic Retail Market Report – June 2007, Ofgem, July 2007.

⁸ The UK Fuel Poverty Strategy, Defra and DTI, November 2001.

benefit from liberalisation; and the provisions of the Utilities Act and the regulator's Social Action Plan are intended to ensure that the regulatory system takes appropriate account of the needs of people on low incomes.' Now suppliers are to prepare a response by winter 2008-2009 and, in the event that these responses are inadequate, the Government reserves the right to legislate on the issue. In these circumstances NEA would expect revisions to the pricing regime for prepayment to be applied retrospectively.

6. Social tariffs

6.1 The Department for Business, Enterprise and Regulatory Reform and the six main energy suppliers have reached agreement on the amount of additional industry support for vulnerable and other disadvantaged customers⁹. It is proposed that suppliers increase funding for such measures from the current annual level of £56 million to £100 million in 2008-2009, £125 million in 2009-2010 and £150 million in 2010-2011. BERR estimates that if this funding were to be used purely to offset fuel costs it could take 100,000 households out of fuel poverty; it should be noted that NEA estimates there to be some 4.5 million fuel-poor households in Great Britain at present.

6.2 The debate on social tariffs has intensified over the period since energywatch published its consultation paper in late 2006¹⁰ but the deal between Government and suppliers does not advance understanding of what is proposed. There is no indication of eligibility criteria for assistance or the proposed form or amount of assistance for eligible households (clearly the reference to 100,000 households being removed from fuel poverty relates only to a fraction of households to be assisted through supplier programmes).

6.3 NEA notes that the level of support from suppliers at 2010-2011 (£150 million) equates to the sum identified by energywatch as the cost of equalising charges for two million social tariff beneficiaries (gas and electricity) with those made to direct debit customers¹¹. This modest level of assistance would benefit less than half of fuel-poor households, even assuming that assistance could be precisely targeted.

⁹ BERR News Release 2008/078, April 11 2008.

¹⁰ A Social Responsibility?, energywatch, November 2006.

¹¹ A Social Responsibility?, The energywatch consultation on the nature of social tariffs in the energy market: report and recommendations,(Table1.4), energywatch, May 2007.

6.4 In fact, with current annual expenditure on social tariffs at £56 million, and assuming that existing programmes will be maintained, there will be minimal additional resources in the first year (£44 million). NEA does not believe that this represents a 'proportionate' response by energy suppliers and urges Ofgem to intercede with Government on behalf of disadvantaged energy consumers.

6.5 Existing supplier investment in social tariffs is extremely variable¹². At the positive extreme is the British Gas Essentials Tariff with a potential customer base of 750,000 households, potential annual expenditure of £90 million and current spend of some £44 million. Setting an industry target for expenditure of £100 million in 2008-2009 raises the possibility that British Gas could, in theory, cut back on its current commitments and still comply with arrangements brokered by Government. It is crucial that other supplier spending should be increased to British Gas levels rather than that there should be any question of reductions in expenditure by British Gas.

6.6 In negotiations on proportionality, it will be necessary for Government and Ofgem to specify the characteristics of those households who are to have access to a social tariff rather than, as now, leaving this decision to the discretion of energy suppliers.

6.7 Finally, NEA notes the near universal practice of describing supplier activity under the Carbon Emissions Reduction Target (CERT) as though the source of the necessary expenditure were company profits rather than, in effect, a levy on customers. It is unclear whether resources devoted to social tariffs or equivalent interventions are to be raised from supplier profits or, more likely, from adjustments to charges levied on other customers.

¹² Proportionality of social tariffs and rebates: Paper for energywatch, Cornwall Energy Associates, January 2008.