National Energy Action (NEA) response to the Levelling the cost of standing charges on prepayment meters consultation

About National Energy Action (NEA)

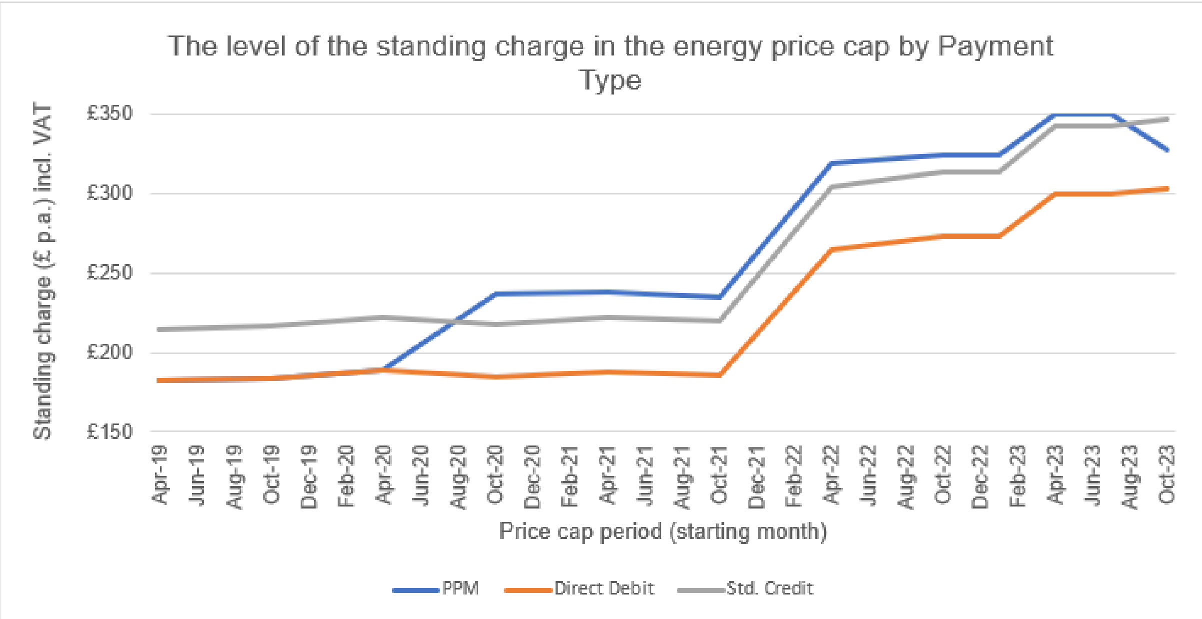
NEA[1] works across England, Wales, and Northern Ireland to ensure that everyone in the UK[2] can afford to live in a warm, dry home. To achieve this, we aim to improve access to energy and debt advice, provide training, support energy efficiency policies, local projects and co-ordinate other related services which can help change lives.

Action for Warm Homes

Background to our response

NEA has consistently advocated for payment premiums to be eliminated in the energy market. Historically, our focus has been on the premium faced by prepayment users, which before the pandemic, was the larger differential. While NEA has and will continue to welcome efforts to reduce this differential through modifications to the price cap methodology (most notably on the allocation of debt costs), this has come at the cost of a widening differential for households that pay by standard credit. Under the October 2023 price cap level, standard credit households will be paying on average £129 more than households that pay by direct debit[3].

Standing charges for prepayment households have increased significantly over the last few years. When the new price cap levels come into effect in October 2023, households will be paying around twice as much on standing charges alone, compared with the April 2019 price cap level.[4]



This significantly impacts prepayment households and their ability to maintain energy supply, leading to more instances of self-disconnection and for longer periods, in addition to impacts on consumer physical and mental wellbeing.

NEA is therefore pleased to see that Ofgem is consulting on the levelisation of standing charges for prepayment households with an option for levelisation of debt-related costs which impact standard credit customers unfairly. However, there would remain areas of unfairness in the market, such as significant variations across regions, which NEA would like to see Ofgem address through a future package of work as soon as possible.

Summary of our response:

Our response, in summary, focuses on:

- The need for prepayment standing charge levelisation
- Reducing bad debt costs for standard credit users
- Fairly allocating bad debt costs

Each of these areas is discussed in more detail below.

<u>The need for prepayment standing charge levelisation</u>

Households often use alternative payment methods than direct debit because they have some level of financial vulnerability. For example, a household may have been forcibly moved onto a prepayment meter because they cannot afford their bills. Penalising these households, which are financially vulnerable, through price differentials, essentially amounts to adding to their costs as a direct result of their vulnerability.

Prepayment users are more likely to be fuel poor, more likely to have a very low income, and more likely to be disabled, be a single parent, and have multiple vulnerabilities when compared to the average customer.[5] With standing charges for the October 2023 price cap level due to be twice as high for the average dual fuel prepayment household compared to 2019, low-income households will have less budget available to go towards energy consumption. The result of this will be an increase in the number of households self-disconnecting and an increase in both the frequency and duration of self-disconnection.

Reducing standing charges for prepayment customers is imperative. These charges have the most negative impact for this group due to the prevalence of rationing and self-disconnection). A rationale for reducing standing charges for prepayment users has been set out by Ideal Economics.[6]

NEA is pleased that the UK Government has stepped in to remove the premium paid by households on prepayment meters (PPM) and is keen to ensure the prepayment premium is ended on a permanent basis. NEA expects, in line with the government’s policy intentions, that Ofgem will end the premium from April 2024 through this package of work.[7]

<u>Reducing bad debt costs and therefore the payment differential for standard credit customers</u>

Like prepayment households, households using standard credit are more likely to be fuel poor compared to direct debit households.[8] Standard credit households are more likely to be a single parent, more likely to have a lower income and much more likely to be elderly.[9] In response to the call for evidence on levelisation of payment method differentials earlier this year we argued that reducing the standard credit premium/differential must be a priority.[10]

There is a specific unfairness that comes from the allocation of debt-related costs in the price cap. Currently, these costs are allocated based on which payment types are most likely to incur them. This is counter-productive. It places a higher cost burden on those households that are least able to afford their energy in the first place.

Households move onto standard credit for a variety of reasons, including because their monthly direct debit is simply unachievable. A household may also be using standard credit because they do not feel comfortable giving control of their bank account to a third party through the direct debit system. The current system penalises both cohorts for little reason.

Placing an additional burden on the most financially vulnerable households leads to increasing their financial vulnerability and increasing their debt risk. This is why **NEA supports Option 3,** which proposes to levelise prepayment and direct debit standing charges, levelise the ASC bad debt allowance, and to levelise debt-related costs.

However, **we would like to see the levelisation of debt-related costs be levelised across standard credit and direct debit customers only.**

Fairly allocating bad debt costs

As households that pay by standard credit or prepayment are significantly more likely to be in fuel poverty, NEA believes that the most progressive way of levelising debt-related costs would be to distribute the costs across households who are least likely to be fuel poor, and those who are most likely to be able to afford such costs. Using payment types only to group households, this group would be those that pay by direct debit.

The cost analysis provided in the consultation document outlines that under either option 2 or 3, the cost to dual fuel direct debit households will be approximately the same, £11 per year. However, the benefits of standing charge levelisation under option 3 are significantly less for prepayment consumers, as the levelisation of debt-related costs offsets the reductions in standing charges. This means the typical dual fuel prepayment household is only £12 better off in option 3, compared to £54 better off under option 2 by itself. In NEA's view, this is a sub-optimal outcome. This is why NEA proposes removing prepayment households from the levelisation of debt-related costs, meaning that the standard credit reductions would be placed on direct debit households.

While NEA understands that Ofgem is conscious about the risk of reducing the incentive for customers to pay by direct debit, we do not believe that the proposal would do that. Since 2020, the payment differential between standard credit has been widening, until recently. The differential grew to more than £200 in April 2023, and the differential remains significant, at £129, for the October 2023 cap period. Despite this, the number of households using standard credit has grown in the same time period.[11] This shows that price is not the primary driver in payment method. NEA also notes that under the option 3 scenario as it is outlined in the consultation, the payment differential for standard credit customers is still significant at £85, equivalent to the payment differential in 2020 when the cap was set at £1,162[12].

Therefore, **NEA's primary recommendation is that option 3 would provide the best outcomes, in terms of fairness, for vulnerable energy consumers. However, we would like to see a variation of this option implemented which levelises debt-related costs from standard credit across direct debit households only.**

Our Response to the Consultation Questions

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

NEA agrees with many of the views outlined in the case for change, particularly around the risks relating to higher standing charges for prepayment households. High standing charges make it more difficult for prepayment households to maintain their energy supply, which can negatively affect customer health and mental wellbeing. On account of Ofgem's statutory duty to consider the needs of vulnerable households, NEA believes it is right that Ofgem is considering practical measures to tackle inequality through payment method differentials.

However, the case for change lacks discussion around the fairness that comes from the allocation of debt-related costs in the price cap. Currently, these costs are allocated based on which payment types are most likely to incur them. NEA believes this is counter-productive. It places a higher cost burden on those households that are least able to afford their energy in the first place. This creates higher debt risk for households paying by standard credit which in addition to impacts on health and wellbeing, can create risks to energy suppliers' financial stability. We believe this should be included in the case for the introduction of levelisation of payment methods.

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

No, NEA believes the policy considerations are sufficient. We are particularly supportive of the levelisation process being enduring and that it should be applied to both cap and non-cap tariffs.

NEA would like to see Ofgem further consider how to eliminate premiums on payment methods paid by fuel-poor households on an enduring basis. In that regard, we agree with the need for the processes being designed as part of this work to be agile. We would also like to see Ofgem consider further how it can eliminate the unfairness of regional costs which will require a separate package of work (discussed further in response to question 6).

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

NEA believes that PPM and DD standing charge levelisation is essential, but we would prefer to see levelisation measures which go further to eliminate unfairness arising from payment differentials.

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.**

Compared to the base case of Option 1, Option 2 does not go far enough to eliminate unfairness. Under Option 2, the standard credit differential will remain at approximately £129 compared to direct debit. NEA believes that standard credit bad debt charges which form a significant proportion of this differential should be levelised across direct debit households. As households that pay by standard credit or prepayment are significantly more likely to be in fuel poverty[13], a more progressive way of levelising debt-related costs is to distribute the costs across households who are least likely to be fuel poor, and those who are most likely to be able to afford such costs. Using payment types only to group households, this group would be those that pay by direct debit.[14]

According to the government's fuel poverty statistics for England in 2022, 27.8% of households with an electricity prepayment meter are in fuel poverty, compared with 10.5% of households that pay by direct debit. The primary reason for this is that the median income for prepayment households is much lower than the median income for direct debit households.[15] We therefore believe that it is not ideal for costs to be added to prepayment unit rates, as this will significantly reduce the benefits that Option 2 will bring to prepayment households.

Nonetheless, reducing the standard credit differential is necessary. As part of the workstream on the involuntary instalment of prepayment meters, Ofgem is predicting an increase in bad debt costs per household of between £4 and £16.[16] Without action, this will further the differential between standard credit and direct debit households.

It is counter-productive to allocate debt-related costs to the payment methods from which debt costs originate. Additionally, according to Ofgem's own research, only 55% of all households are aware that energy costs vary depending on the type of payment method used. Furthermore, far fewer still know which methods are more or less expensive.[17]

Households move onto standard credit for a variety of reasons, including because their monthly direct debit is simply unachievable. A household may also be using standard credit because they do not feel comfortable giving control of their bank account to a third party through the direct debit system. The current system penalises both those who knowingly accept a payment premium due to their distrust of the market, and those who are oblivious to the additional costs they are paying. These is little reason for this penalisation.

The differential between standard credit and direct debit, and the associated impacts of these options on that differential, is cited as a risk for reducing the incentive on suppliers to promote direct debit as a payment method to households. Since the number of households that pay by standard credit has increased along with the payment differential in the last few years, NEA believes that the price differential should not be considered as correlating to households' choice of payment method.

NEA would therefore like to see Ofgem explore the possibility of levelising debt-related costs between standard credit and direct debit households only. This is the fairest and most progressive approach to levelisation.

5) **How should we ensure that levelisation transfers are correctly applied to customers on tariffs not covered by the cap (I.e. uncapped)?**

The Energy Price Guarantee (EPG) required suppliers to apply a reduction to tariffs which had otherwise been set in a business-as-usual manner. Assessing compliance with that scheme therefore would have faced the similar issue of ensuring that the discount had been appropriately applied. One approach may therefore be to require a similar package of tariff reporting, that demonstrates a proportionate approach to levelisation transfers, to be collected from suppliers.

6) **Do you agree with our proposal not to levelise across regions?**

Regional variations are a significant source of unfairness in the market. For instance, all households in North Wales and Mersey pay at least £86 more than households in London for their standing charge (including VAT).[18] Households in both areas are paying to experience the same service outcomes. Since this unfairness is separate to what is being discussed in this consultation, NEA do not believe it can be appropriately addressed through this package of work. Nonetheless, NEA would like to see Ofgem address this unfairness in a future package of work as soon as possible.

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

Yes. The measures proposed in this consultation would be universally applied, so the households who are in need of targeted support will sufficiently receive some support through these measures. Additionally, we view payment differentials as an issue of fairness, not necessarily about affordability, so targeting is not necessary for this package of work.

However, in line with our response to question 6, we believe that if steps are not taken to address the differential for standard credit customers, households in regions such as North Wales and Mersey, or Scotland, will remain in a position whereby they are paying significant premiums for their location and their payment method. NEA therefore believe that targeted support may be needed for those households if broader steps to reduce the standard credit differential are not implemented.

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

It's critical that this package of work is delivered in time for April 2024 when the levelisation support provided under the EPG ends. We believe that new licence conditions are essential for ensuring the benefits are appropriately applied, however the establishment of new licence conditions is lengthy and could increase the time required to deliver the outcome of this package of work.

NEA therefore believes that Ofgem should prioritise delivering these benefits through the price cap by April 2024 and should simultaneously work to develop licence conditions to ensure that the costs/benefits are distributed properly, especially for households on uncapped tariffs. By separating these actions, Ofgem can reduce the delivery risk for April 2024.

References and Notes

[1] For more information visit: www.nea.org.uk.

[2] NEA also work alongside our sister charity Energy Action Scotland (EAS) to ensure we collectively have a UK wider reach.

[3] Price Cap for October 2023,, Ofgem, 2023
[4] Compare Price Cap for October 2023 to Price Cap April 2019, Ofgem, 2023; Ofgem, 2019
[5] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016
[6] Reforming standing charges for prepayment customers, Ideal Economics, 2023
[7] Spring Budget 2023, HMT, 2023
[8] English Fuel Poverty Statistics, DESNZ, 2023
[9] CMA Energy Market Investigation Appendix 9.9 – Prepayment, CMA, 2016
[10] NEA response to Ofgem's call for evidence on levelising payment method cost differentials, NEA, 2023
[11] English Fuel Poverty Statistics, DESNZ, 2023
[12] April 2020 Price Cap, Ofgem, 2023
[13] English Fuel Poverty Statistics, DESNZ, 2023
[14] Consumer Impacts of Market Conditions survey, Ofgem, 2023
[15] English Fuel Poverty Statistics, DESNZ, 2023
[16] Involuntary prepayment meter decision, Ofgem 2023
[17] Consumer Impacts of Market Conditions survey, Ofgem, 2023
[18] Regional levelisation analysis module, Ofgem 2023