

Citizens Advice response to Ofgem consultation on providing financial protection to more vulnerable consumers

Below Citizens Advice responds directly to the the questions posed in the consultation. A more detailed account of our views on the issues covered by questions one to three are supplied in the accompanying document *Vulnerable consumers and high energy prices*.

Question 1 – What are your views on our preferred approach of identifying consumers for safeguard tariff protection by primarily relying on data-matching? And Question 2 – What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable consumers?

We provide a combined response to these two questions to avoid repetition, as both explore the same issue.

We agree that data matching should be the preferred approach to identifying consumers. The data to enable effective mapping of vulnerability characteristics onto households already exists through the benefits system. The Government has committed¹ to bringing forward secondary legislation this spring that would allow the Department for Work and Pensions to share the relevant data with suppliers.

Because suppliers would be told who was eligible, and would not need to actively identify eligible customers, the costs of implementation should be reduced. In addition, data matching should reduce the risk that eligible customers miss out that would exist with using a Priority Service Register (PSR)

¹ [insert hansard or BEIS select committee comment]

based route where it is commonly recognised that many eligible consumers have not signed up.²

There is a risk of adverse unintended consequences if a PSR+ route is followed, because it may discourage suppliers from incurring expense to find PSR customers if the consequences of this are that they would then need to offer that customer a discounted tariff.

The PSR is also a clumsy proxy for ability to pay because its focus is on health issues, not financial issues. While the two will often overlap - for example, we know that pensioners and disabled people are more likely to be on SVTs and less likely to shop around - it is not an ideal proxy. And because the focus of the PSR is on consumers with health issues, it will not capture the large number of healthy vulnerable consumers who are struggling to meet their energy costs.

To try and fill that gap, the consultation suggests that in addition to those that are on the PSR, the cap could also be applied to consumers where the supplier has evidence of financial distress, for example who are in debt or in arrears. In principle, this sounds reasonable, but we have concerns that the practicalities of this approach have not been fully rounded out to date. The consultation document itself only gives around half a page to outlining this option. For it to be workable, we think that you would need to develop a more detailed case for exactly what criteria suppliers would need to use to identify eligible customers under this approach. Without this, we have some concerns that this approach may lead to a patchwork of different approaches across different suppliers - with the potential for inconsistent treatment of customers.

Notwithstanding the above, and recognising that the passage of powers that would enable wider data matching are outside Ofgem's control, we could support a PSR+ approach if it is the only option on the table.

Question 3 – Are there other methods for identifying vulnerable consumers that we should consider, either alongside or as an alternative to, our preferred approach?

We have not identified any practical alternatives to the data matching or PSR+ approaches.

² [insert figures on missing eligible PSR numbers from Ofgem review.]

Question 4 – What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.

We think that all suppliers should be required to provide safeguard tariff protections to vulnerable consumers and there should not be exemptions, for example based on customer number thresholds, as exist for some other social or environmental policies.

While the bulk of disengaged vulnerable customers are currently with the largest suppliers, smaller suppliers will also have them in their portfolios. It should not be assumed that just because a customer is with a small supplier that they are automatically engaged with the market and therefore do not need protection because they can help themselves. In practice, customers can end up with small suppliers both because of engagement (for example, by choosing to switch to them) or through inertia (for example, by inheriting a supplier chosen by the former tenant or the ongoing landlord when moving in to a property). There is a very real risk that some vulnerable consumers are left unprotected if there is a small supplier exclusion from this policy.

An exclusion for some suppliers would complicate advice provision and may confuse customers. For example, carers may erroneously believe that a vulnerable customer is protected by the safeguard when actually they are not. There is also the issue that supplier growth, or contraction, may cause them to move through the threshold that mandates the provision of the safeguard, causing further confusion.

More broadly, we have concerns that excluding some suppliers from the costs associated with providing the safeguard tariff would provide a perverse competitive distortion. In simple terms, that exempt suppliers would be rewarded for doing the wrong thing. The need to tackle poverty is a society-wide issue, and there is no moral justification for some suppliers being exempt from contributing. It would be entirely wrong if suppliers were able to improve their positions in best buy tables by avoiding the costs associated with doing the right thing.

We recognise that there is potentially an implementation practicality issue associated with which suppliers are obliged to offer the wider vulnerability safeguard tariff. As you highlight, around 93% of customers are served by

suppliers who are obliged to support the Warm Home Discount scheme while the remainder are not. The former will therefore have the architecture in place to support data matching while the latter will need to set it up from scratch. For proportionality reasons, you therefore suggest that only suppliers who are obliged to participate in the WHD scheme would be required to use the new data matching arrangements while other suppliers would be subject to the PSR+ backstop approach.

If these safeguard arrangements were to be enduring, we would have significant discomfort with this approach, as we regard the PSR+ approach as clearly the second best option on the table (for our reasons for this, please see the combined answer to questions 1 and 2). However, we recognise the design expectation that it may only be in place for a few months before it is superseded by the wider default tariff and that any implementation delays associated with waiting until all suppliers have data matching systems in place could jeopardise whether the wider vulnerability safeguard can be put in place for the coming winter. Because of this, we can accept the argument you make for a blend of data matching for the biggest 15 suppliers, with PSR+ for the residual, as a short term stop gap.

This being the case, we would like to see you progress work to enable wider data matching in parallel, and as a high priority. Both the energy minister, Claire Perry, and your CEO, Dermot Nolan, have indicated the need for vulnerable consumers to be protected on an enduring basis - and we agree.³ The wider legislative price cap that is currently before Parliament is explicitly time limited and it would be prudent to ensure that the work put into delivering the temporary wider vulnerability cap can support whatever enduring solution is put in place. We think that market wide data matching should be a design assumption for that enduring cap.

We would also like to see you robustly explore smaller suppliers assertions that it would be impractical or unreasonable to put data matching in place. We are worried that there may be perverse incentives on suppliers to try and over-play the difficulties in order to defer or dilute their obligations under this policy. Energy is a regulated essential services market and all suppliers need to be pulling their weight.

³ In evidence sessions to the BEIS Select Committee on 17 January and 10 January 2018 respectively.

Question 5 – What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?

We support Ofgem's proposal that the extended safeguard tariff protections would apply regardless of meter type. While the prevalence of vulnerability can differ by meter type, there is no evidence that it does so by such an extent that it would justify the exclusion of some meter types from eligibility.

While adopting this position, Ofgem appears to have concern that it may be regarded as inconsistent with the PPM cap, noting that 'this position is different to the prepayment meter safeguard tariff, which will not apply to those consumers who receive fully interoperable smart meters.'

We think it is unlikely that this inconsistency would directly affect many households. The definition of a fully interoperable smart meter for the purposes of the PPM cap is one that is either SMETS2 or that has been designated as fully interoperable by the CMA (and to date, none have been so designated). While some trialling of SMETS2 metering is taking place, we are not yet aware of any supplier being in mass rollout of SMETS2. BEIS has recently extended the last date on which SMETS1 meters can be installed until October this year. At some point, SMETS1 meters will be adopted by the DCC and become fully interoperable, but there is no firm timeline for this yet, and little likelihood that it will be before 2019. So the amount of SMETS2 metering, or that which is otherwise designated as fully interoperable, that will be in place for the coming winter looks likely to be limited.

While the PPM price cap will remain in place until 2020, the design life expectancy of the wider vulnerability safeguard tariff is very short, with an intention that it will fall away when the government's price cap takes effect. It is currently the stated intention of government to have its cap in place by this winter, in which case Ofgem's cap may not be introduced at all. But even in the event that the introduction of the government's proposals are delayed, it seems unlikely that Ofgem's cap will be in place for more than one winter. So while it is possible that some eligible households will have SMETS2 meters during the period covered by your proposed cap, it is unlikely that the number will be significant.

We think that excluding those customers from the protections of the wider vulnerability cap would be inappropriate for several reasons.

It may disincentivise the uptake of smart metering if consumers discover they lose the safeguard tariff when they do so. More importantly, it may cause those consumers' financial harm.

There is also no evidence base on which one could build an assumption that consumers with SMETS2 meters would not need protection. We do not yet know whether consumers with that form of metering will be more, less, or similarly engaged than those without it.

Question 6: Which of our two options for setting the benchmark component of the safeguard tariff would be most effective?

We support Ofgem's decision to constrain its choices to either extending the PPM price methodology based on the CMA benchmark, or using a basket of market tariffs. We agree that other design options are on the table but that it is unlikely that they could be developed in time to allow for implementation by winter 2018/9.

We think that either of these two options could be made to work, but have a preference for extending the PPM methodology based on the CMA benchmark. There are several reasons for this.

Principal among these is that this methodology is tried and tested. It has reduced the bills faced by eligible consumers markedly, as shown in figure 1. While concerns were raised that the PPM cap would constrain price spreads in the market, we have seen them bounce back after an initial tightening, as shown in figure 2. We do not have direct access to PPM switching data, but we note Dermot Nolan's recent comments to the BEIS select committee that switching may have reduced but remains at reasonable levels and that firms specialising in serving PPM customers are continuing to grow.⁴ So while it may have its critics, there is broad evidence that the PPM price cap is working.

⁴ Q367, BEIS Select Committee oral evidence session in its Pre-legislative Scrutiny of the Draft Domestic Electricity and Gas (Tariff Cap) Bill, 10 January 2018.

Figure 1: Average SVT prices across different payment methods in the last year⁵

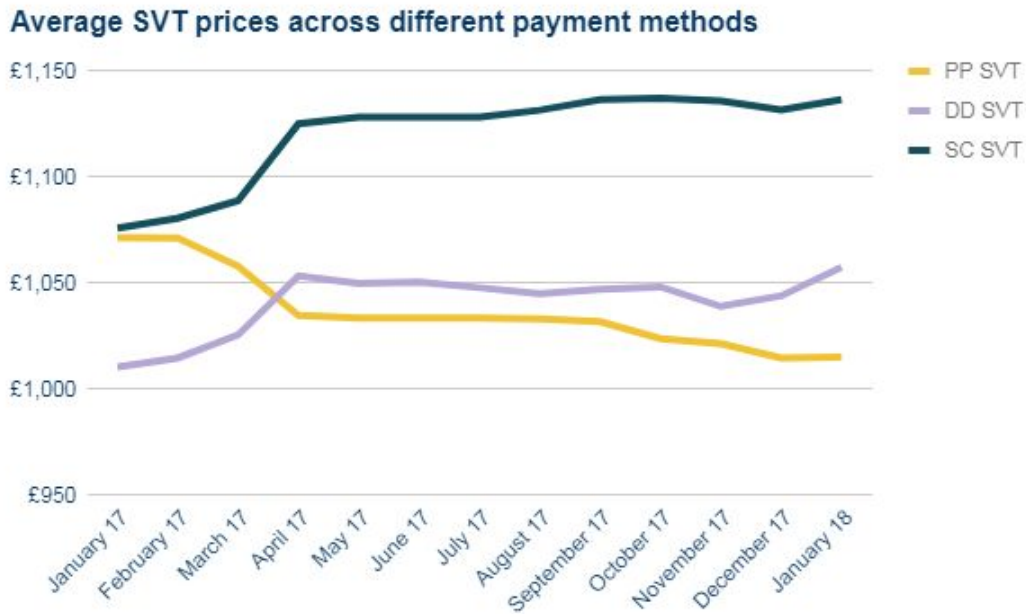


Figure 2: Spread of PPM prices on the market in the last year⁶



⁵ Based on Ofgem standard consumption values (updated for the new TDCVs from October 2017). Data snapshot taken on first working Monday of each month. Dual fuel, including both paper and paperless billing. Economy 7 tariffs excluded. Average across all regions the tariff is available in. Based on energylinx data, which may not represent the whole of the market.

⁶ National average figures used, based on a dual fuel consumer using the average annual household consumption of 3,100 KWh electricity and 12,000 KWh of gas. Spread calculated on the first working Monday of the month.

Because market participants have been operating with the PPM price cap in place since April 2017, and would have been preparing for its introduction for a number of months before that date, they should have a greater degree of familiarity with the operation and likely outcomes of that kind of model than with the basket of tariff approaches. This may make implementation more straightforward with fewer risks of surprises than trying to develop the alternative basket approach. This seems particularly beneficial given how tight the time constraints are for you to develop and implement something for this coming winter.

The new vulnerability cap will sit alongside the PPM price cap rather than replacing it. For consistency reasons, this also suggests that it may be appropriate to use an extension of its methodology for the vulnerability cap rather than a wholly new methodology such as a basket of tariffs. If very different methodologies are used, there is a risk that the two caps could diverge significantly in their outcomes, eg with the size of price cuts or rises under one differing markedly from the other. While that may be wholly technically legitimate given different methodologies were used, it could cause problems in communicating the safeguard tariff to the public and may be perceived as unfair.

Finally, given it would be an extension of a mechanism that is already in place, we can have a high degree of confidence that the modified PPM approach could be put in place in time. While we think it is probable that the basket model could also be delivered in time, the fact that it is untested and has a range of design issues that would need to be ironed out, means that it is less certain. The difficulties in resolving all the potential issues in time may also mean it is more at risk of unintended consequences and/or successful legal challenge.

For the avoidance of doubt, our comments above should not be taken as blanket opposition to a basket based approach and we would look to work constructively with Ofgem to make it work well for consumers if it becomes your favoured option. Although we regard it as the more problematic of the two approaches this does not mean we think it is wholly unworkable.

Question 7: Do you have any comments on the design issues for either of our two options?

Common design issues

Policy cost exemptions

A common design issue for both is that some suppliers are subject to policy cost exemptions. An efficient level of costs for those suppliers may therefore materially differ from that of those who are subject to those costs.

This may imply that price caps should be set at two different levels: one for those suppliers who are exempt, and one for those who are not.

This two-tier approach is not envisaged in the consultation document and we suspect that you may not wish to go down that route because of the complexity that would bring. The vast majority of vulnerable customers on SVTs are with suppliers who are not exempt from policy costs. It may also be the case that vulnerable customers on SVTs with exempt suppliers are more likely to switch and therefore less in need of protection, although this assumes that the decision to choose a smaller supplier was made by them and was not, for example, inherited when they moved into a property.

If the wider vulnerability cap were to become an enduring solution, we would encourage you to consider giving a two tier cap further thought. But noting that it may currently only be in place for a few months, or possibly never be implemented at all if the government's own broader SVT price cap can be put in place for winter 2018/19, we can understand why you may not wish to put in place separate caps for exempt and non-exempt suppliers.

Frequency of safeguard tariff update

There is scope for volatility in the cost drivers underlying either methodology. In the case of the CMA methodology, this will mostly be driven by movements in wholesale prices and, to a lesser extent, by policy costs. The basket methodology would likely also reflect the former of these but possibly not the latter, as the best buy tables are usually dominated by suppliers who are exempted from policy costs. Suppliers are free to introduce new tariffs, or to withdraw acquisition tariffs, at any time, meaning that the contents of a 'best buy' basket could change very quickly.

Ofgem will need to balance the needs of cost reflectivity (which would tend to suggest frequent resets of the cap) against simplicity, stability and implementation cost (which would tend to suggest much more infrequent resets of the cap). We are also mindful that this wider vulnerability cap may only be in place for a single winter, perhaps not even that, which may limit the value in developing a complex methodology for determining when it should be reset. In practice, the approach taken with the PPM cap of a six monthly reset appears to represent a pragmatic compromise. So we support Ofgem's proposal to adopt that frequency for the wider vulnerability cap.

We also think that suppliers should be given two months notice of the revised level of the cap, in line with the PPM approach.

Benchmark at nil consumption

The current PPM price cap applies a non-zero charge at nil consumption, reflecting that there are some fixed costs incurred with supplying a customer regardless of the number of units that they use. As one might expect, it is based on the CMA's view of the cost to serve prepay customers, while the broader vulnerability cap will apply to direct debit or standard credit customers instead.

The consultation suggests three possible approaches to this issue:

- Simply to reuse the PPM benchmark at nil consumption
- To create a new benchmark by subtracting the [CMA calculated] PPM uplift value from its PPM benchmark at nil consumption, or
- Creating a new benchmark by requesting data from the Big 6 suppliers.

We favour the second of these approaches.

We think that the first approach would be inappropriate as it would result in consumers paying too much, given that PPM is a higher cost [to serve] payment method.

There are some notional attractions in the third approach as it would allow more contemporary cost to serve data to be collected and used in the calculation, and might reduce the risk of legal dispute if a common figure can be agreed with the suppliers. That said, it should be noted that when formulating its price cap the CMA was trying to set an efficient benchmark cost to serve, and not to simply reflect the actual benchmark cost to serve. Given the CMA concluded there was significant inefficiency in domestic supply, there is a risk that following this approach would allow cost pass through of inefficiently incurred costs. We are

also mindful of the risk of gaming - that it may be in the interests of these suppliers to inflate the data provided to form this revised estimate - and of the extremely short timescale both for the development of your methodology and of its likely lifespan before replacement by the government's broader cap. Finally, we are mindful that the CMA put considerable effort into its analysis of suppliers cost to serve and that no supplier chose to appeal the findings of its market review.

Because of this, we think the second approach is the most balanced and the one that should be pursued.

Benchmark at TDCV

We note Ofgem's observations that if the PPM methodology is used, it would have to be based on the historical TDCV used at the time, but that if the basket approach were adopted the current TDCV could be used.

From the explanation, it is not clear to us why the PPM methodology could not be updated to reflect current TDCVs when it can be modified in other areas (such as benchmark at nil consumption). It would be desirable to use current TDCVs and we encourage you to give further thought on whether this can be achieved. As you come forward with final proposals, we would find it useful if you could draw out the materiality or implications of any use of historic TDCV in the methodology as it is not easy to estimate this based on the published materials.

Payment method uplifts

There are different costs to serve associated with standard credit and direct debit customers. If these were nugatory, the case for adopting a single blended cap that covered both would be strong on the grounds of simplicity and ease of implementation. Ofgem notes that a range of plausible approaches for estimating cost to serve differentials could give very different figures, and that suppliers have some discretion on allocating their costs, which may mean that the gap between the two payment methods is not as wide as is generally thought.

The most definitive figure that is currently available is the ~£100 gap calculated by the CMA, however. This is sufficiently material that we think it may be unsound to apply a single blended cap. It could result in competitive distortions between suppliers depending on the payment make up of their customer base. It may also result in a cap that is unreasonably generous to suppliers in terms of

the return they can make on direct debit customers while unreasonably tight in terms of the return they can make on standard credit customers, with the potential for unintended knock-on consequences on eg customer service.

Headroom

In theory, the inclusion of headroom above the calculated efficient cost of supply is designed to allow for a spread of prices on the market, retaining incentives to switch. This argument is not wholly convincing, because it implies that SVTs are an acquisition product, with consumers switching from one SVT to another. While there will be cases where consumers do switch between SVTs, in practice they are rarely if ever an acquisition product. The price spread among SVTs is therefore much less relevant to the incentives to switch than the price spread between SVTs and the cheapest acquisition tariffs on the market, which are usually 1-2 year fixed deals.

We note your argument that suppliers may choose to set all their prices at the maximum level allowed for by the safeguard tariff, in effect negating the benefit of headroom. We agree that this is a risk, particularly given the greater likelihood that SVT consumers are price takers who will not shop around.

However, provided the level of the cap is below current SVT prices it is likely that they would still be better off. The experience of the PPM cap is informative here: while most prices are clustered around the [headroom inclusive] cap, there are still some deals significantly undercutting that cap and most eligible consumers saw their prices cut when it was introduced. Again, because SVTs are not typically an acquisition product, the spread among them is less relevant to the incentives to switch than the spread between them and short term fixed deals.

If the arguments for the inclusion of headroom to retain switching incentives is weak, we are more sympathetic to the arguments for its inclusion to reflect differing levels of service quality. One might expect a competitive market to deliver a variety of different service level offerings from 'no frills' low cost through to a more expansive but higher cost offer. Allowing headroom may therefore give more room for plurality in the quality of service offered to consumers. But while noting this, we are not aware of any objective data from the CMA investigation or elsewhere that would allow you to establish the value of this kind of quality dividend. Additionally, because headroom would be available to all, suppliers would be free to set their own prices anywhere up to

the cap, and SVT customers tend to be price-takers, there may be little to stop no frills suppliers prices taking advantage of the headroom.

In the event that you determine that headroom should be included, we have no strong preference between the percentage based or absolute value uplift approaches you identify. While you suggest the absolute approach may not be objective, we think that argument could equally be made against the percentage approach. For the purposes of simplicity and consistency, it may be that basing the uplift on the £30 figure developed by the CMA for the PPM price cap is appropriate.

Design issues with the CMA PPM methodology

Smart meter costs

While it would likely lead to a higher figure, we support the proposal from some suppliers that charges associated with the DCC should be incorporated into the methodology and managed as a cost pass through item. This is because those figures are known and published, and it should improve the accuracy of the calculation.

In terms of wider indexation, we note that a number of suppliers argue that the PPM methodology underestimates the costs of smart rollout and that there should be an upward adjustment in the allowed for cost to serve. While we hear those arguments frequently, underlying data to substantiate them is less readily forthcoming. We think that the onus is on suppliers to convincingly - and quickly - demonstrate that the actual delivery costs are higher than estimated if they want any greater allowance for them in the price cap that is set. We are not in a position to reach a view on whether they can rise to that challenge.

We note that the National Audit Office has commenced a review on the costs of the smart meter programme. In the event that you choose to develop a new estimate of smart costs for the purposes of the price cap we would encourage you to work with the NAO.

Design issues with the basket approach

Policy cost exemptions

We would expect the 'best buy' tables to be dominated by smaller suppliers who are exempt from some policy costs. But it would appear unreasonable not to

make some allowance for those costs when creating the price cap. We can see two possible ways to do this:

- (a) include all suppliers in the basket of tariffs, but then apply a policy cost uplift to the price derived from this; or
- (b) include only suppliers who are exposed to policy costs in the basket of tariffs.

Approach (b) may be simpler, because it would remove the need for Ofgem to derive a policy cost uplift. But it may also create issues around the liquidity or gameability of the index, as far fewer tariffs would be included in it.

The structure of the basket

The biggest issues we see with the basket approach are around the structure of the basket. Almost by definition, the contents of the basket are likely to be quite unlike SVTs. Market leading tariffs are disproportionately likely to contain one or several of the following characteristics: be fixed term; be fixed price; be for direct debit customers; be online billing only; have exit penalties; be with suppliers who do not offer the Warm Home Discount. Because of this, like for like comparison with SVTs will be crude at best. Ofgem would need to work out how to adjust for those differences.

We agree that it is important that there are a reasonable number of tariffs in the basket, both to reduce the risk of gaming and to ensure the basket is representative of market prices. While any number chosen is at risk of being arbitrary, we think your suggestion of using ten probably finds a reasonable balance between being large enough to reduce gaming risks while small enough to be simple to implement and to reflect keenly priced deals.

We recognise the issue you raise of the difficulty in identifying and excluding unrepresentative outliers from the basket. Unfortunately we see no easy way of resolving that problem - as noted earlier, market leading deals tend to have inherently different characteristics to SVTs. On balance, we think it would be simpler and more workable to try and apply a generic uplift to the costs of the basket than to try and exclude individual tariffs from the basket. While neither approach would be easy, the latter may lack objective robustness and appear arbitrary. In the event that you do determine an approach whereby some tariffs are ineligible for the basket, it will be very important that stakeholders, whether market participants or consumer advocates, have a clear understanding of what is in the basket and what is not. Given the sheer volume of tariffs on the market

and the challenges that can present in understanding the characteristics of each one, it may be necessary for you to maintain and publish a definitive list of what is in the basket at any given time, to avoid the risk that stakeholders reach a different understanding of what is included.

Regarding tariff duration, we cannot see how you can make an objective choice on what to include or exclude from the basket. It may be preferable to simply allow all tariffs, regardless of the length of the term if they are fixed term, to be eligible for the basket.

Regarding tariffs per supplier, we understand the issue you raise regarding the risk that a supplier could unduly influence the basket if more than one of its tariffs were eligible for inclusion in it, but are not convinced this is a major issue. Given how high profile this policy intervention is, we think that any abuse of this kind would be very easily spotted and may well be actionable under competition law as an attempt at market manipulation. In any event, there are natural incentives on suppliers not to try and stuff the basket with unsustainably low cost tariffs because they would have to honour those tariffs.

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on the issues that matter to them.

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