Citizens Advice
1 Easton St, London
WC1X 0DW

citizensadvice.org.uk

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Standing charges: domestic retail options

We welcome the opportunity to respond to Ofgem's emerging thinking on options relating to standing charges.

We have previously set out our concerns in relation to standing charge reform[1], and in the current context we do not support proposals to reduce the level of operating costs recovered via standing charges and increase them from unit rates.

Ofgem's assessment shows these changes lead to relatively small gains for low usage households, and much greater losses for those with relatively high usage. This includes some people on low incomes who cannot safely reduce their energy use due to living in homes with poor energy efficiency, old fashioned heating systems and medical requirements for a warmer home or electrical equipment.

The paper argues that there is 'clear consumer interest in increased control over their energy bills'. We agree - but these proposals would increase control for some consumers at the expense of less control for others who cannot reduce their usage. They would also reduce control for prepayment meter users, who will face even higher costs in winter, increasing the chances of self-disconnection. We think this risk is under-explored in the paper, with more emphasis on the risk of accruing standing charge debts which existing policies should tackle.

We recognise that this options paper will be followed by more detailed consultation in the context of wider changes as part of the operating costs review. However, at this stage we are concerned that, in relation to the 4 key areas identified in Ofgem's consumer interests framework[2], the changes clearly act against the target outcomes, or have not been adequately explored in the impact assessment:

[1] Citizens Advice (2023) Why standing charges are fairer than you might think
[2] Ofgem (2023) A competition framework for the household retail market | Ofgem

- Fair pricing - these options could mean costs risk being less efficient and less fairly distributed, with negative impacts on some consumer welfare risks identified (e.g. for disabled consumers who are identified as being more likely to lose out). Ofgem has not adequately evidenced the impacts in some other key areas, like fuel poverty, self-disconnection and debt.

- Customer service - Ofgem identifies there is a risk that suppliers with more low usage consumers will lose revenue and could provide a worse service, while suppliers with more high usage consumers will face fewer incentives to operate efficient services than they currently do.

- Low cost transition - Ofgem recognises that consumers who use more electricity (including for EVs and heat pumps) will face higher costs, while consumers who can be more efficient with energy or install solar panels and batteries will face lower costs. However, it has made no attempt to quantify which of these is more important for an efficient transition, and therefore what impacts its proposals would have on costs.

- Resilience - the changes could make suppliers less resilient by making their cost recovery more dependent on changes in weather and the consumption by their customer base. On the other hand, they would also hand an unearned increase in profits to firms with customers who are higher energy users and in colder winters.

Where risks have been identified they increase as more recovery of operating cost is moved from standing charges to unit rates. In areas where the impacts have not been adequately analysed it is incumbent on Ofgem to provide further analysis during the next round of consultation - and especially prior to its further planned work on network charging and wider cost recovery.

Whilst this consultation considers changing the balance of how operating costs are recovered, how actual costs are incurred will be unchanged. So, we are concerned that the distortions arising from making reforms through the price cap could lead to worse outcomes for consumers overall. Ofgem should set out more clearly how its proposals align with the requirements of the price cap legislation to:

- create incentives to improve supplier efficiency - as these changes will arbitrarily strengthen these efficiency incentives for some suppliers and weaken them for others.

- set the cap at a level that ensures suppliers compete effectively - these changes would increase the scope for competition for higher users, while reducing it for lower users

- the need to maintain incentives to switch - these incentives will be increased for some consumers and decreased for others based on how much energy they use

The paper says that these changes are ‘a zero sum change where, in financial terms, some consumers will benefit, and other consumers will not’. However, we are concerned that because of some of the negative impacts in areas like the net zero transition, competition, incentives for efficiency and supplier resilience, costs may actually increase overall for consumers. We recognise that Ofgem presents a range of options and that the impacts of smaller changes are likely to be more limited - but so will any benefits.

The public response to Ofgem’s call for input demonstrates the charged debate and negative sentiment around standing charges, and political commitments have been made to see them reduced. However, we think the significant risks involved for some of the most vulnerable households mean any changes that increase unit rates should only go ahead if there are appropriate mitigations in place, and should only be carried out as part of a more comprehensive approach which can limit the risk of market distortions.

We welcome Ofgem’s commitment to working with the Government on this. We’ve set out how targeted bill support based on the existing Warm Home Discount scheme is the best way to achieve this in the near term, and could also tackle the wider affordability challenges in the sector.[3]

Answers to selected consultation questions are provided below.

Yours sincerely,

Alex Belsham-Harris

Head of Energy Consumer Markets

[3] Citizens Advice (2024) Fixing the foundations: The need for better targeted support for energy consumers

Responses to selected questions

Q1. Do you have any views on our case for change?

We agree with Ofgem's assessment that abolition of standing charges would have significant negative impacts for some vulnerable low income households that Ofgem cannot mitigate, and this general dilemma equally applies to partial rebalancing options Ofgem considers in the paper.

The case for change says that there is 'clear consumer interest in increased control over their energy bills', but we're concerned that changes like these will simply mean more control for some users (those with lower usage) and a loss of control for others, like higher users who cannot reduce their usage. Even lower usage customers may lose other types of control over their energy - for example, suppliers may be less willing to serve them and they may be less likely to be able to make savings in the market.

Ofgem says that 'standing charge reform will not directly reduce the total cost of energy faced by consumers as a whole', but there are indications that it could, in fact, increase overall costs by driving inefficient outcomes. Ofgem's analysis shows that these changes could reduce the resilience of some suppliers while weakening efficiency incentives for others, which could increase costs overall.

Ofgem sets out how the current split of operating costs recovery between standing charges and unit rates was set based on observations made at the time the price cap was introduced, but that 'with most customers now on tariffs covered by the price cap, there is no longer a market benchmark to reflect, and so we need to make a judgement on the appropriate balance'. However, it provides no rationale as to why this would have diverged in the intervening years. The impact assessment includes analysis that standing charges in acquisition tariffs do still generally track those in the cap, which may suggest this split remains appropriate. We also note that when the price cap was introduced standing charges were set below the level indicated by the bottom up cost assessment[4].

We're concerned that this approach could set a poor precedent for decisions in relation to the price cap more broadly. We are keen to see more evidence in the next phase of the operating costs review on the extent to which operating costs are fixed, and how this may have changed since the price cap was first introduced.

Q2. What are your views on the range (£20-£100) of operating costs we are considering shifting from standing charges to unit rates? Should it be higher? Within this range, is there a value you would favour and why?

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[4] Ofgem 2018 Default Tariff Cap - Overview Document Para 2.96

We don't support any reform of standing charges unless it is accompanied by measures to mitigate the impact for people with lower incomes and high energy needs. We are also concerned that distortions arising from making reforms through the price cap could lead to worse outcomes for consumers overall.

The higher options risk unacceptable harm to some low income users who would face bill increases of over £100 a year, and to people who prepay or pay by standard credit who would face much higher seasonal disparities in costs. They would also begin to have more significant impacts on the resilience of suppliers with more consumers who have lower energy usage.

Ofgem should also clarify how these changes would align with SLC 7, which prevents suppliers from charging consumers on deemed contracts at rates that would mean 'revenue significantly exceeds the licensee's costs of supplying energy' to any class of domestic customer. Options at the upper end of this range would appear to conflict with this rule, by requiring suppliers to significantly over-recover their costs of supplying some customers in order to be able to cover lost revenue elsewhere.

Q3. What are your views on the trade-offs and impacts we have identified for consumers and suppliers? Should any of these take more or less significance in our assessment, and are there any important impacts we have not considered?

While the draft impact assessment is helpful, in some areas it is lacking, particularly in relation to prepayment and debt. The paper focuses on the risks of standing charge debt leading to self-disconnection, but does not provide analysis of the risk that the proposals impact on the seasonal disparity in costs faced by consumers. This would also lead to higher winter bills for people who pay by standard credit, who are already at higher risk of debt which may increase with even larger winter bills. These effects would be greatest in colder winters and for higher users.

Previous Ofgem analysis[5] set out that the average energy user spent more than twice as much on energy in the coldest months than in the warmest - it should update this analysis to reflect the impact of increasing unit rates, and use this to inform the trade off of risks in relation to self-disconnection. In general, the risk of self-disconnection and debt should be given more significant weight in Ofgem's analysis.

As set out earlier, we are concerned by the high losses some individual consumers on low incomes could experience through the options presented. Ofgem presents the results of an income-weighted distributional analysis to assess a net positive income weighted saving for consumers overall. It should also publish the impact of this analysis on winners and losers separately to support a deeper understanding of the range of outcomes low income consumers will experience.

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[5] Ofgem (2021) Supplier Licensing Review: reducing credit balance mutualisation

The impact assessment should also take a clearer approach to the impacts of changes on fuel poverty. It currently includes analysis of how many low income households who gain from the policy are in fuel poverty, but it does not provide equivalent figures for low income households who lose out.

Ofgem also takes a 'both sides' approach to the environmental benefits and risks of standing charge reform, qualitatively describing that lower standing charges incentivise greater take up of solar panels, while dis-incentivising heat pumps and electric vehicles. It's important that future stages of the review quantify these impacts on the overall cost of the transition.

There is an associated risk that a growing number of consumers are able to 'free ride' through use of solar panels and batteries - avoiding paying a fair portion of the costs. These options are generally used by more affluent households, and aren't accessible for many due to their cost, property type and tenure. This could lead to wider mistrust that the net zero transition is proceeding fairly.

In relation to suppliers the operating cost allowance is set using what Ofgem describes as a 'stringent' approach to incentivise efficiencies in supplier operations. Moving costs from standing charges to unit rates will arbitrarily loosen these restraints for suppliers with customers with higher usage, while tightening them for suppliers with lower usage customers.

Ofgem's assessment of these impacts focuses on profitability, but there are also risks that supplier customer service declines at these suppliers who struggle to recover their costs. It will also increase the impact of weather events on cost recovery and could reduce the resilience of suppliers during price shocks if consumer usage declines as a result.

There are also risks that switching incentives will reduce for low users, who may be less attractive and may find it harder to find tariffs that can make savings compared to the price cap. We are already concerned that changes like MHHS will mean some consumers are increasingly left behind by the market.[6] These changes could further 'trap' some customers on the price cap, and result in a market built around the needs of the affluent.

Overall, while Ofgem identifies and quantifies some of the right trade offs, it doesn't take proper account of others. It also treats much of the assessment as a 'zero sum' change, when we think there is generally a greater risk of higher costs overall from these changes. We are therefore not confident in the current judgement that 'consumers as a whole benefit from the changes discussed in the paper'.

Q4. What are the changes required, if any, to the price cap to facilitate a reduction in the level of the operating costs charged through the standing charge?

Not answered.

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[6] Citizens Advice (2024) Don't settle for second best: Ensuring energy market reforms stack up for people

Q5. Could mandating suppliers to have at least one low or no standing charge tariff available to customers help promote competition in this area of the market?

We do not expect such a rule to increase the availability of low or zero standing charge products, and that such products would be sold with very high unit rates or rate structures to prevent under-recovery of fixed costs. The experience of the Smart Export Guarantee should be instructive, where suppliers are required to offer export tariffs, but many offer these at very low prices.

We support the adoption of an FCA-style Consumer Duty being introduced for the energy market, including rules requiring all products to offer fair value. However, even with such a protection in place it would be hard to see how the regulator could require firms to freely offer products in the market that were loss making.

Q6. How could we create flexibility in how costs are recovered between the unit rate and standing charge without reducing the protection provided by the cap?

We agree with Ofgem's assessment that changes to allow more flexibility risk reducing the protection provided by the cap, and therefore think this would be undesirable. We are also sceptical that consumers would make choices between suppliers on the basis of their default tariff product design, or make active choices between these products once they have defaulted. Any decisions to fundamentally change the operation and design of the cap should considered as part of Ofgem's separate review on the future of the price cap

Q7. In enabling greater diversity in standing charges on default tariffs, what, if any, safeguards would be needed to protect vulnerable consumers?

Not answered.

Q8. What are the key considerations we should take into account in developing options for smoothing spend for prepayment meter customers?

We agree that seasonal disparities in costs can be very challenging for people who prepay. However, the question of how to smooth prepayment meter costs sits somewhat oddly in a paper which sets out a range of options which would have the effect of making costs <u>less</u> smooth for consumers who use prepay (and standard credit).

Ofgem focuses instead on the risk that consumers with prepay meters can build up standing charge debts while off supply which can make it harder for them to reconnect. However, suppliers are already required to identify and support customers who are self-disconnecting, including through additional support credit and affordable repayment plans. Particularly where smart meters are installed, this should be effective in overcoming the risks related to standing charge debts. Ofgem should set out clearly if it considers this not to be the case.

Q9. Do you have any views on our considerations for the allocation of network and policy costs?

We welcome a joined up approach between the Government and Ofgem on the allocation of these costs. By working together this should ensure a wide range of policy tools and approaches can be used to ensure prices are fair and to mitigate harmful impacts of changes.

This should include better targeted energy bill support, to mitigate the impacts and improve affordability for people on low incomes, and consideration of policies to prevent 'free riding' by some consumers, including de minimis charges for households with solar panels.

We also support Ofgem's view that the regional variance in standing charges should be considered as part of REMA, rather than as part of its current standing charges review, to ensure alignment with wider decisions on locational pricing.