

# Competitive Energy Markets and Low Income Consumers

William Baker, Centre for Sustainable Energy



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## Introduction

In 1996, the UK Government embarked on a radical programme to fully liberalise the gas and electricity markets. Supply competition already existed in the industrial and commercial sectors. The new programme, begun in April 1996 and completed in May 1999, meant that every domestic consumer in Britain (but not Northern Ireland) could choose their gas or electricity supplier<sup>1</sup>.

This paper presents the findings of a national research project into the impact of energy competition on low income households. The project was established by the National Right to Fuel Campaign (NRFC) and Centre for Sustainable Energy (CSE) because of concerns that low income consumers were losing out under competition.

Earlier research by the two organisations into the impact of the pilot phase of gas competition in South West England found that new gas suppliers were not interested in the custom of prepayment meter customers (NRFC/CSE, 1997 & 1998). New suppliers were offering substantial discounts to Direct Debit consumers but not to prepayment meter or frequent cash payment consumers<sup>2</sup>. This led to a substantial price differential between Direct Debit and prepayment tariffs<sup>3</sup>.

This research aimed to establish whether the trend identified by the earlier research was continuing as competition unfolded across the country and was extended into the electricity sector. The research also aimed to investigate the impact of competition on suppliers' marketing activities, service standards and consumer information. Factors such as fuel poverty and social exclusion, particularly financial exclusion, were also investigated to ascertain whether they had any influence on consumer access to competitive markets.

Finally, the research sought to influence policies towards low income consumers, particularly those of the Government, regulator and fuel companies, by proposing recommendations based on the research findings. The paper will therefore conclude with a summary of the NRFC and CSE's recommendations.

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1) This policy meant that gas consumers could now buy their gas from a number of alternative suppliers to British Gas, the previous national monopoly supplier of gas. Similarly, they could buy electricity from alternative suppliers to their local Public Electricity Supplier (PES), which previously existed as regional monopolies. In practice, PESs account for most of the new entrants to the gas market, while British Gas is the dominant competitive electricity supplier. However, liberalisation has also led to substantial mergers and restructuring within the energy industry.

2) Prepayment meters and frequent cash payment schemes are fuel payment options that are mostly used by people on low incomes.

3) A Direct Debit tariff means that the fuel supplier automatically withdraws a fixed amount, typically every month, from the consumer's bank account. A prepayment meter tariff is a 'pay as you go' system whereby the consumer only receives a gas or electricity supplier by keeping their prepayment meter in credit. To do this, they need to either 'charge up' a SMART card or purchase keys or tokens from a local outlet, eg post office, local shop or direct from the supplier. Many suppliers use prepayment meters as a means of recovering overdue payments from people with arrears. The meter is calibrated to recover current consumption, plus an agreed weekly contribution towards reducing the arrears. Currently 49% of electricity consumers in Britain pay by Direct Debit and 16% by prepayment meter. 49% of gas consumers pay by Direct Debit and 9% by prepayment meter (Ofgem 2000a). These figures are based on a sample of approximately 2,200. Actual proportions will be available shortly as a result of Ofgem's new fuel supplier monitoring arrangements. Other common tariffs include quarterly credit and fortnightly/monthly budget plan. To take advantage of a Direct Debit tariffs, the consumer has to have a bank account and sufficient money passing through their account to provide the financial stability for allowing automatic deductions. For this reason, many low income consumers with tight budgets prefer not to use Direct Debit. Further, about 1.5m households in Britain do not possess a bank account meaning they are automatically excluded from using Direct Debit (HM Treasury, 1999). Prepayment meters are popular with many low income households because they allow the consumer to budget their fuel expenditure on a weekly or fortnightly basis.

4) Low income was defined as people falling within the lowest 20% income group.

5) The Utilities Act, passed in 2000, reformed the regulatory arrangements for gas and electricity markets. The Act's provisions include:

- the establishment of a single regulatory authority (Ofgem) and single independent consumer body (energywatch);
- a new Ministerial responsibility to provide guidance to the

- regulatory authority on social and environmental objectives;
- a new Government power to set energy efficiency targets for suppliers on a statutory basis from 2002 onwards (currently this is a discretionary power of the regulator); and
- a new Ministerial reserve power to cross-subsidise certain groups of consumers if it becomes apparent that they are not benefiting from competitive energy markets.

6) The Group recently (February 2001) launched a draft Fuel Poverty Strategy (DETR, 2001). This sets out the Government's targets for combating fuel poverty over a 10 year period. It includes references to the role of competitive energy markets in reducing fuel poverty.

7) Ofgem's Social Action Plan (Ofgem, 2000b) aims to ensure that consumers have a range of tariff options and payment methods to suit their circumstances and that energy suppliers provide appropriate advice and help with debt management and energy efficiency. Provisions include changes to licence conditions to improve protection for disadvantaged consumers, the establishment of a number of research and pilot projects to identify the needs of disadvantaged consumers and improvements to the access of consumers in debt to competitive markets. All suppliers are also now required to offer their customers facilities for paying bills in cash fortnightly or more frequently (frequent cash payment options). However, suppliers are not required to offer such facilities free of charge to consumers. Many consumer bodies were disappointed that Ofgem chose not to insist upon free provision.

8) A recent report from the Electricity Association Fuel Poverty Task Force (EAFPTF, 2000) lists over 30 fuel company initiatives designed to alleviate fuel poverty. Some of these represent major new projects that typically offer energy efficiency investment and advantageous tariffs (3 examples are described in depth in Competition Monitor Bulletin Number 6 (Marshal, Kavanagh & Nichels, 2000)).

9) 6 Bulletins were produced over the research period. Each Bulletin also featured articles from prominent figures in the energy industry, for example Helen Liddell (the former energy minister), and representatives of the regulator, fuel companies and consumer bodies.

10) In 1998, Ofgem's predecessor regulators (Offer and Ofgas) introduced new licence conditions to protect electricity and gas consumers from poor marketing practices (Cooke & Barnes, 1998). They obliged suppliers to make sure that customers understood they were entering a contract, to properly manage and train sales agents and to audit any sale within 14 days to make sure that the customer was happy with the sale's conduct and still wished to go ahead.

11) Ofgem estimate that 7.5 million households in Britain are now 'dual fuel' consumers (Ofgem, 2000c)

12) Suppliers are obliged to provide a range of special services to pensioners, disabled people and people who are chronically sick. Services

include the provision of information appropriate to blind, partially sighted, deaf or hearing impaired consumers; the provision of special controls and adapters for appliances; and for gas consumers a free safety check. Suppliers are also obliged to keep a register of consumers eligible for receipt of special services (the Priority Services Register).

13) Suppliers are obliged by licence condition to offer energy efficiency advice upon request and provide 'general information on reducing future gas (electricity) bills by using gas (electricity) more efficiently where gas (electricity) charges remain unpaid' (Ofgem, 2000b). Suppliers should also give advice on external sources of energy efficiency advice and grants (to the supplier).

14) 'Fuel Direct' is a payment method currently only available to people claiming Income Support Benefit and in arrears to their gas or electricity supplier. Its use has dropped dramatically over recent years, partly as a result of changes to Benefits Agency policy, partly because fuel suppliers consider prepayment meters a more effective method of recovering debt and partly because the system is antiquated and complicated to administer. There are plans to improve the system and make it available to all Benefit recipients (not just those in debt) through a Post Office-based system (Ofgem, 2001). The system would operate on a similar basis to the Irish Household Budget Scheme.

15) These questions related to Panel members' views on a number of innovations currently at the planning or pilot stage. For example, Norweb is piloting a project whereby prepayment meter consumers with electric central heating pay a fixed weekly amount throughout the year into their prepayment meter. The advantage to consumers is that it allows seasonal variations in heating costs to be evened out throughout the year. Suppliers are also investigating the possible use of credit unions to receive fixed payments towards consumers' fuel bills. It is hoped this would allow people without bank accounts to take advantage of Direct Debit-type facilities and thereby benefit from similar discounts to Direct Debit tariffs.

16) The Government has announced that from 2003, all benefits will be paid by automated credit transfer (ACT) into claimants' bank accounts. Parallel to this, the Government intends to establish a Universal Bank, accessible from Post Offices, that will open up banking services to people currently without an account.

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## Conclusions and recommendations

The research findings show that energy competition had a major impact on the Panel. Many had benefited from the lower prices and innovative services on offer. However, many others were left behind. Their needs for flexible or pre-pay payment methods, energy efficiency investment or special services often went unmet.

The research found a polarised energy market, focused mainly on payment methods. Few gas prepayment meter consumers on the Panel had switched supplier, while about a half of Direct Debit payers had. Such distortions were even more pronounced within the 'dual fuel' market, which was dominated by Direct Debit payers.

Other drivers of polarised energy markets included payment history (arrears etc), the need for special services (due to disability or age) and housing conditions, particularly poor thermal efficiency. Key factors that led some consumers to fall behind within competitive energy markets were social exclusion, financial exclusion and poverty.

NRFC and CSE are convinced that open energy markets cannot meet certain aspects of social need. We believe that the Government should establish a 'standing conference' of key 'stakeholders' to determine those areas of policy where markets have failed and to help develop sustainable energy policies that tackle market failures. The conference should address environmental externalities, as well as social; suggest appropriate forms of Government intervention to overcome market shortcomings; and give advice on reconciling conflicting areas of social and environmental policy.

We also believe that all fuel suppliers should be required to meet certain minimum social obligations covering such issues as access to services, universality and charging structures. These should be subject to continual review and improvement, in line with rising living standards. Ministerial guidance to the regulatory authority should give unambiguous guidance on social policy and provide a framework for Ofgem's Social Action Plan. This would reverse the current situation whereby Ministerial guidance (still to be formalised) appears to represent post priori legitimisation of the Social Action Plan.

While new fuel supplier initiatives targeted at fuel poor households are welcome, it is not yet clear whether they will reverse the polarising trends within competitive markets. We believe that a system of independent scrutiny and monitoring should be established to assess the impact of supplier initiatives on fuel poverty, ie whether they actually lift people out of fuel poverty.

We urge Ofgem and energywatch (the new combined gas and electricity

consumer council) to embark on a major programme of consumer education. This should address such issues as comparison of tariffs, 'dual fuel' and standards of service. Fuel suppliers should supply price information in a format that allows consumers to compare suppliers' offers easily.

We strongly urge Ofgem to undertake a major investigation into the 'dual fuel' market to ascertain whether there is evidence of suppliers achieving market domination through their past position as incumbent suppliers. This is urgently required given that prepayment meter customers appear to be getting an even worse deal than in the separate gas market. Given the lack of competition in the prepayment market, we do not believe it appropriate for Ofgem to lift price controls.

We believe Ofgem should undertake the following actions to improve the standards of service offered by fuel suppliers:

- Extend the list of groups eligible for inclusion on the Priority Service Register to families with young children and take action to improve take up of services offered through the Register.
- Improve standards for meter readings and estimated bills, including positive action to promote advance meters. This is particularly important for people on low incomes because unexpectedly high bills after long periods of estimated readings can cause considerable financial stress.
- Incentivise suppliers to invest in debt prevention, eg through capping debt repayment levels, improved payment facilities and making sure energy advice/investment is integrated with debt management procedures.
- Encourage suppliers to provide or fund 'benefits checks' and independent money advice for low income consumers.

We believe that Government programmes to tackle social and financial exclusion should include the following:

- Encourage fuel suppliers to become partners in such programmes.
- Improve physical access to financial services within deprived areas.
- Recognise the popularity of Post Offices and claimants' desire to 'pick and mix' the format in which they receive different benefits and pensions, ie cash and bank account.
- Take action to reduce Post Office charges for the transaction costs involved in handling bill payments and action on fuel suppliers (through Ofgem) to offer free frequent payment facilities, ideally at Post Offices.
- Modernise and extend Fuel Direct so that it is available to all Benefit recipients and carries a fuel tariff discount due to its potential convenience to fuel suppliers.

NRFC and CSE would welcome comments on the research findings and our proposals for improving the access of low income consumers to competitive energy markets.

Liberalisation of energy markets is less advanced in mainland Europe than in Britain. NRC and CSE hope that other national governments take note of the British experience of liberalised markets and take steps now to protect vulnerable and low income groups. Further, the rapid convergence of energy markets at the European level, coupled with the European liberalisation programme, pre-supposes the need for European-wide regulatory structures. Such structures should fundamentally address social and environmental objectives.

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## Combating fuel poverty and financial exclusion

The extent of fuel poverty among Panel members is illustrated by the following findings:

- People without bank accounts, lone parents, gas pre-pay and frequent cash consumers and people with gas arrears were particularly likely to live in hard-to-heat housing.
- Pensioners, particularly single pensioners, were more likely to ration their fuel, ie leave rooms unheated, turn heating off during cold weather and choose between fuel and other expenditure.
- One third of prepayment meter consumers had 'self disconnected' during the previous year. ('Self disconnection' occurs when a consumer fails to keep their prepayment meter in credit due to either running out of money or inability to get to their local charging facility to purchase more credit).

The research investigated a number of innovative services designed to combat fuel poverty and financial exclusion (these are typically at the pilot stage or are planned for the near future).

Few Panel members showed any interest in paying their fuel bill by Fuel Direct<sup>14</sup>, in its current form. However, many more were interested if a discount was also offered. Those currently paying by prepayment meter were particularly interested in 'Fuel Direct plus discount'.

Few Panel members showed any interest in making fixed weekly payments through prepayment meters, joining credit unions or having their benefits/pensions paid straight into bank accounts<sup>15</sup>. However, the interviewers only gave a limited explanation of such innovations.

Many Panel members were aware of the Government's plans to introduce automatic transfer of benefits/pensions into bank accounts and the implications of such plans to their particular circumstances<sup>16</sup>. Many were concerned it would undermine their ability to 'pick and mix' how they received their benefits or pensions. This was because they often received a variety of benefits or pensions and preferred to cash one benefit/pension, whilst having another paid into an existing bank account.

Many Panel members spontaneously stressed the importance of supporting local Post Offices. They valued the 'social role' played by local Post Offices (for example a place to meet friends) and they valued the convenience of paying fuel bills in tandem with the use of other Post Office services. Many local Post Offices have closed in recent years, particularly in rural and inner city areas. Many Panel members expressed concern over this trend, suggesting that Post Offices are particularly valued by low

income groups (pensioners in particular).

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## Social exclusion

A relatively high proportion of full-time workers on the Panel had switched gas supplier, while relatively low proportions of retired people (particularly lone pensioners) and minority ethnic groups had switched.

Access to competitive energy markets was associated with access to other related services, eg financial services. Residents of large 'Council' estates and inner city areas had less access to banks, doctors and Post Offices than residents of suburbs and small towns. Lack of access to basic services forms an important element of social exclusion.

People paying for gas and electricity and gas by pre-pay or frequent cash were also likely to pay for other common services, eg rent, water and telephone, by cash. The research found that many low income consumers lived in a 'cash economy' and preferred not to use banking services to carry out common transactions.

The recent closure of local bank branches may have contributed to this characteristic. However, issues intrinsic to living on a very low income provide the most important explanation. Use of cash gives low income households greater control over their budgets, prevents the build up of debts and prevents the potential for accruing bank charges due to running accounts in arrears (if they have accounts).

Although a lower proportion of frequent and pre-payers on the Panel had bank accounts with Direct Debit facilities than consumers paying by other payment methods, over half still had access. The research therefore concluded that wider problems of poverty, financial insecurity and social exclusion explained why this group did not use Direct Debit, as much as lack of access to the facility itself.

A significant minority of cash and pre-payers paid extra 'hidden' costs associated with their payment method - 5% paid transaction costs and 20-23% paid extra travelling costs. This group lived on very low incomes and paid costs not associated with other payment methods.

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## Competition and standards of service

Only about a fifth of Panel members eligible for special services (older and disabled consumers) were actually registered for receipt of services<sup>12</sup>. The remainder were not aware that they were entitled to receive special services. Whilst all of British Gas's eligible consumers who were aware of their eligibility did register, only a quarter of 'aware and eligible consumers' of new suppliers registered for special services.

Only half of Panel members were interested in receiving general energy savings advice<sup>13</sup>. 'Energy efficiency' did not mean much for many Panel members, despite their low income and the fact that energy efficiency advice could help them save money on their bills. However, this figure rose to 69% when Panel members were asked if they were interested in receiving more specific forms of advice or service eg advice on use of heating controls, 'low cost or no cost' fuel saving measures. The finding has important implications for how the energy efficiency 'message' is marketed. It suggests that energy efficiency means more to people, particularly those on low incomes, if the 'message' is more specific and targeted.

4/5 of Panel members in difficult-to-heat homes had gas arrears, compared to 1/5 of Panel members in easy-to-heat homes. However, only 7% of Panel members with arrears reported that they received energy advice from their supplier as a means of dealing with their arrears. This is despite the fact that suppliers are obliged by licence condition to provide energy advice to people with arrears. Most people with arrears reported that they were offered a prepayment meter as a means of reducing the arrears.

Suppliers believe that the problem arises not so much as a result of their failure to offer advice but rather because people in arrears are unwilling to receive advice from their creditor. The research therefore concluded that people with arrears were likely to be more receptive to energy advice if offered by independent providers in conjunction with money advice.

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## The development of energy markets

The 'dual fuel' market grew dramatically over the study period. ('Dual fuel' deals allow consumers with both a gas and electricity supply to buy their fuel from one single supplier. In some cases, this means they only receive one bill.) By the end of the research it represented the largest single sector, accounting for 43% of all Panel members' custom (not including those without a gas supply)<sup>11</sup>.

The research found that the development of the 'dual fuel' market was spurred by the opening up of the electricity market to competition. Most Panel members switching electricity supply did so to take advantage of a 'dual fuel' deal, typically with British Gas. The research found little evidence to suggest the existence of a separate 'stand alone' electricity market (unlike the situation in the gas market) ie few people switched electricity supplier without also taking advantage of a 'dual fuel' offer. For this reason, much of the analysis focused on the payment methods of gas 'switchers' and 'dual fuel' consumers, rather than electricity 'switchers'.

81% of Panel members who had switched gas supply had changed to a 'dual fuel' arrangement. Similarly 77% of electricity 'switchers' had moved to one single 'dual fuel' supplier, namely British Gas (this figure does not include those without a gas supply). The figures suggest that only a small number of Panel members heeded Ofgem's advice to compare 'dual fuel' offers with 'single fuel' offers from separate suppliers (Jones, 1999).

The profile of switchers' payment methods did not change substantially over the study period. By the end of the research, only 4% of gas 'switchers' paid by prepayment meter, while 49% paid by Direct Debit. The comparative figures for British Gas consumers were 15% and 39% respectively.

Competition was even more distorted within the 'dual fuel' market. 1.5% of 'dual fuel' consumers paid for gas by prepayment meter, while 60% paid by Direct Debit. 'Dual fuel' consumers of British Gas were even less likely to pay for gas by prepayment meter (0%) and more likely to pay by Direct Debit (75%). The profile of British Gas consumers' payment methods within the 'dual fuel' market was the mirror opposite of that found within the single gas market (in comparison with new suppliers). In marketing 'dual fuel', British Gas appears to have deliberately targeted Direct Debit consumers and avoided prepayment meter consumers.

Competition appears to have encouraged both 'switchers' and 'non-switchers' to change payment method to take advantage of discounted tariffs. The proportion of Panel members who paid for gas by Direct Debit increased from 33% to 43% over the study period.

Between a quarter and a third of the total number of people changing gas supply from one questionnaire to the next were switchers moving back to British Gas. The most common reason given by this group was 'poor service from previous supplier' - typically billing problems and 'failure to read meter'.

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## Consumer information within competitive energy markets

Doorstep sales staff represented an important source of information on switching gas supplier for Panel members (less so for electricity supplier, where television adverts were more important). Most Panel members who had switched gas supplier did so as a result of canvassing from sales staff. While many Panel members reported a positive experience with sales staff, a significant minority reported negative experiences. These included sales staff providing misleading information or applying undue pressure on consumers to switch supplier. Such practices contravened Ofgem's licence condition on marketing<sup>10</sup>.

Most Panel members who had changed supplier had not 'shopped around' to find the best deal for their circumstances. Only a minority compared the prices on offer from more than one supplier. There was no evidence of consumers becoming better informed as energy markets matured. Price was the most important factor that influenced the decision of Panel members to 'switch' supplier. However, 'service quality' was much more important than 'price' for 'non switchers' or people moving back to British Gas (none of the 'electricity switchers' moved back to their original supplier).

Many Panel members were not aware of the tariffs and charges associated with different payment methods. Most Direct Debit payers (90%) were aware that Direct Debit was the cheapest method. However, 50% of prepayment meter consumers erroneously believed that they were paying by the cheapest method. Panel members who paid by prepayment meter because the meter was already there when they moved in to their house were particularly likely to think they were paying by the cheapest method.

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## Research methodology

The research project established a national panel of 300 low income households (the Panel)<sup>4</sup>. 11 interviewers, based in 7 different regions within Britain, interviewed the panel four times over a 2 year period. Each questionnaire included questions on a particular theme, eg energy advice or social exclusion, plus a common set of standard questions. The Panel was not statistically representative of the population. The research findings were therefore only indicative of wider trends within competitive markets.

The research took place during a period of rapid transition in energy markets. At the start of research, gas competition was still relatively new and electricity competition had yet to start. Regulation, particularly in the form of price controls, played a central role in shaping the development of competitive markets. By the end of the research, Ofgem (the gas and electricity regulator) had abolished most price controls in the gas market and intended to follow suit in the electricity market one year later (Ofgem, 2001). The industry had also changed dramatically, with the sector increasingly dominated by large, multi-utility and multi-national companies.

A number of significant developments also took place during the research period. These included the Government introducing a Utilities Act<sup>5</sup>, the establishment of an Inter-Ministerial Group on Fuel Poverty<sup>6</sup>, implementation of Ofgem's Social Action Plan<sup>7</sup> and the introduction of a number of major supplier initiatives that were deliberately targeted at the 'fuel poor'<sup>8</sup>.

The research aimed to assess the impact of some of these developments on the Panel. It also aimed to provide an 'early warning system' of regressive trends within the newly liberalised markets. This was achieved by producing a regular Bulletin that highlighted recent findings from the research and reviewed significant developments within competitive markets<sup>9</sup>.

The research was also advised by senior representatives from the DTI, Ofgem, the Electricity Association (the electricity industry's trade body), local government and consumer organisations. Issues arising from the research could therefore be raised with the advisory group and possible solutions identified.

The following sections summarise the findings of the research. NRFC and CSE have published a full report of the findings, entitled '*Competitive energy markets and low income consumers*' (NRFC/CSE, 2001).

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