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Addressing the poverty premium

Approaches to regulation

Donald Hirsch

Consumer Futures

Consumer Futures

Consumer Futures represents the interests of consumers across essential, regulated markets. We use compelling evidence, expert analysis and strong argument to put consumer interests at the heart of policy-making and market behaviour.

Consumer Futures is the statutory representative for consumers of postal services across the United Kingdom, for energy consumers across Great Britain and for water consumers in Scotland. It maintains the powers, responsibilities and duties of Consumer Focus.

In April 2014 Consumer Futures will, subject to Parliamentary consent, become part of the Citizens Advice service.

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Donald Hirsch, March 2013

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Preface

Transforming responses to consumer vulnerability is a priority for Consumer Futures. This report, based on research by the Joseph Rowntree Foundation, is about how people on low incomes pay more for essential goods and services and what can be done about it. It is widely believed that consumers will best be served by encouraging competition on the basis that this drives efficiency and delivers innovation. However, competition does not always work this way and it is consumers on low income that often lose out, but so do others who are vulnerable for reasons other than low income.

The fact that 'the poor pay more' is not news. This report updates the picture and shows that paying higher prices for utilities and credit can raise the cost of a minimum household budget by around 10 per cent – a 'poverty premium'. The cost of many essentials such as energy and water are likely to rise and while we hope for a tide of economic growth which will lift all, poverty and vulnerability is not going to go away and indeed many people who are not seen as 'poor' will struggle to meet household bills.

It is not a comprehensive survey of pricing practices. Rather, it considers the cumulative impact of such premiums on the lives of people on low incomes and challenges regulators, policy makers and companies to develop and provide essential goods and services that are inclusive, fair and do not penalise consumers simply because they have low incomes.

The report looks at how the poverty premium manifests itself, whether that is by paying by more expensive payment methods, paying more per unit of consumption, paying more because of limited financial and communications capabilities or paying high interest on consumer credit.

It also looks at how markets can create and exacerbate the poverty premium through market failures or by 'cost-reflective' pricing that disadvantages low income consumers. Regulators have a role to play, for instance the energy regulator Ofgem sets a positive example for other regulators and policy makers in a context of serious harm for low income energy consumers and intense pressure to reform the market.

Governments, rather than regulators, have primary responsibility for addressing problems relating to affordability of essential services, which it can help through fiscal measures and other mechanisms. Such action is outside the scope of this report. Regulators however, have the primary role of supervising the behaviour of firms within the framework set by governments. Although this distinction is not absolute as many regulators have specific provisions within their establishing legislation to have regard to specific groups of consumers.

Regulators can take action to make essential markets fairer and more inclusive for those who find themselves in vulnerable situations or at a disadvantage in essential markets. Competitors in markets tend to pick off the most profitable consumer segments and neglect those who are either unprofitable to serve or where profitability is marginal. Hence there is a need to intervene to ensure universal service for things like telecoms and post (average geographical pricing) and to serve specific less profitable segments (social tariffs, light user tariffs, basic bank accounts etc).

Given the shared responsibility between Government and regulators, there is a risk that issues around affordability will fall through the gap. Not just between governments and regulators, but for consumers across markets. More often than not, the same consumers who struggle to pay their fuel bills will be the same who struggle to pay their water bills, their communications bills and so on. Consumer Futures is seeking to promote thinking across market sectors to that regulators can learn from each other about what approach works best for low income and vulnerable consumers. At present each regulator and/or relevant government department seems to approach this differently.

Because this issue is a priority for Consumer Futures, and because we recognise that we do not have all the answers and indeed the answers may be very difficult to identify we will work with those, in governments, regulators, companies and voluntary bodies who share our mission to make essential markets fairer and more inclusive for those who find themselves in vulnerable situations or at a disadvantage in essential markets. We want to identify:

- What are the market causes for the poverty premium?
- What are the limitations/possibilities in the traditional regulatory approaches to the poverty premium?
- What might facilitate the development of holistic and effective consumer vulnerability strategies?

We hope therefore that this report will be a start to engagement with others and that it will be a subject to which we will return.

Mike O'Connor
Chief Executive
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Executive summary

Introduction

As part of its brief to promote positive outcomes for consumers, Consumer Futures is particularly concerned about consumer vulnerability. One aspect of vulnerability is that some groups of consumers can pay higher prices for basic goods and services due to their position in the market. Where these consumers are already on low incomes, this well documented 'poverty premium' adds to the difficulty that they face in making ends meet.

'...its purpose is to develop thinking about and analysis of the poverty premium in ways that can help inform responses by regulators, policy makers and companies that provide essential goods and services.'

This report was commissioned from the Joseph Rowntree Foundation (JRF) to consider the impact of the poverty premium, and approaches of regulators in tackling it, in the provision of essential goods and services in regulated industries. This report is not intended as a comprehensive survey of pricing practices in these sectors. Rather, its purpose is to develop thinking about and analysis of the poverty premium in ways that can help inform responses by regulators, policy makers and companies that provide essential goods and services.

It does this in three main ways.

- It considers the overall impact of such a premium on the lives of people on low incomes.
- It goes beyond previous lists of examples of the poverty premium, to address its multiple causes and forms. In particular, it considers the extent to which those on low incomes pay more because they are more expensive to serve or, conversely because of their weak position in the market.
- Finally, it proposes a way of thinking about the case for different types of intervention, by regulators and others.

Overall, its aim is to encourage regulators to ask certain kinds of questions about how low income consumers might need additional protection, based on particular disadvantages they may face because of how markets and companies operate.

The report focuses on utilities and financial services, including consumer credit, sectors, where people on low incomes have often faced higher costs in meeting essential needs. These are areas where regulation aims generally to protect consumers by ensuring that markets work in a fair and transparent way.

They are also fundamental to people's ability to have an acceptable standard of living, meeting basic physical needs such as keeping warm, social needs such as communication ('utilities' are here taken to include all telecommunications including internet access and broadband) and the purchase of other essential goods and services using various financial products and access to online transactions.

The report asks whether additional protection is needed for people on low incomes because of difficulties they have securing fair treatment in these markets. It also considers the impact a poverty premium can have on the ability of low income households to meet a minimum acceptable living standard, and the importance of this issue in terms of the detriment caused to people's lives.

'...suggests that particular issues for regulation can arise where people on low incomes are at a particular disadvantage in getting fair treatment in markets.'

In considering appropriate roles for regulators, the report acknowledges that some:

- general efforts to help consumers, such as providing good information and ensuring fair competition, will help consumers on low incomes without having to target them
- efforts to give targeted help to people on low incomes, such as social tariffs/bill reduction schemes and help with home insulation or accessing the internet, may not involve regulation (even though they are sometimes supervised by regulators), but need to be initiated by governments.

However, it also suggests that particular issues for regulation can arise where people on low incomes are at a particular disadvantage in getting fair treatment in markets. In particular, if they are poorly positioned to be 'active consumers', they may get a bad deal relative to others, sometimes creating a cross-subsidy to those consumers who suppliers most want to attract. Where this occurs in privatised essential services that were once supplied publicly at more uniform prices, the poverty premium takes on additional importance because, while putting new competitive downward pressures on general prices, it has also created new risks for groups who are in particularly vulnerable situations.

Four types of poverty premium

Four categories of poverty premium are highlighted in this report:

- Paying higher than average utility tariffs for a given amount of consumption, either because of the payment method (such as quarterly billing or prepayment) or because of being on a 'sub-optimal' deal. The evidence shows that people on low incomes are particularly impacted by these tariff effects. They generally have not proved successful at getting the best deals, or are excluded as consumers, in a competitive market.
- Paying more per unit of consumption because of being a low user. This is especially an issue in telecommunications, where tariffs are increasingly structured around inclusive packages, and it has become harder for people on modest means to meet basic needs at much below the average price.

- Paying more because of limited financial and communications capabilities. People on low incomes often have limited choices how to buy things, and if they are not online or do not/cannot pay by Direct Debit, they can end up paying significant premiums.
- Paying high interest on consumer credit. In purchasing essential goods on credit, some low income consumers end up with much higher bills because of high effective interest rates. The evidence shows that this premium can be much greater than is justifiable by the additional risk of lending to them.

Impact on household budgets

'households need to spend between a fifth and a third of all outgoings on utilities and on buying larger items that they are most likely to purchase on credit.'

The importance to people on low incomes of paying more for basic items can be analysed through the prism of the Minimum Income Standard (MIS). This is a benchmark based on research that specifies what households need, as a minimum, for an acceptable standard of living, according to members of the public.

In order to reach this acceptable standard of living, on average households need to spend between a fifth and a third of all outgoings on utilities and on buying larger items that they are most likely to purchase on credit.

New calculations for this report show that paying higher prices for utilities and credit can raise the cost of a minimum household budget by around 10 per cent.

'...paying higher prices for utilities and credit can raise the cost of a minimum household budget by around 10 per cent'

This 10p in the pound premium can contribute significantly to poverty and hardship. For example, for a single person on a low wage (a third above the minimum wage level), it can make the difference between being £9 a week short and being £34 a week short of meeting their needs as specified in MIS. Thus, for a household already falling short of what they need, this effect compounds greatly the detriment of having too low an income for a minimum acceptable living standard.

Moreover, the potential for such detriment is exacerbated where people on low incomes lack certain 'enabling' products such as full banking services or the internet, because this can add to costs across the whole range of household spending.

Underlying causes

Approaches by regulators to the poverty premium are influenced by the nature of its causes, which vary from case to case. We can distinguish:

- **General market failures:** uncompetitive or unfair practices that hit low income consumers particularly hard. In particular, in cases where less active consumers tend to be excluded from the best deals obtained by the most 'active', this can create a cross-subsidy in favour of better-off groups that is hard to justify.
- **Specific market failures:** the failure to supply products that meet the needs of low income groups at competitive prices. Limited competition to supply products suitable for low-end or low-income users can cause prices of these services to be higher than they would be in a properly functioning market. In some cases, such as high-interest credit or prepayment meters (PPMs) there is or has been clear evidence of uncompetitive behaviour leading to large levels of detriment to low-income consumers.
- **Cost-reflective premiums:** Higher prices or overall costs faced by low income families for reasons that reflect the additional cost of supplying them. In some cases, it is possible to reduce these additional costs – for example more low income households connected to the internet and with the financial capabilities to make online purchases and use Direct Debit. In others, such as high insurance premiums in deprived areas, it is much harder. However, it is important that cost-reflectivity should not be a smokescreen for the exploitation of low income consumers: there is risk that suppliers over-charge for the cost difference, which in any case is not always clear-cut. For example, it is not self-evident how the cost of large infrastructure investments should equitably be apportioned between high- and low users.

'The role and scope of regulation is constantly being re-evaluated.'

Both utilities and household credit are already subject to regulatory regimes, whose core function is to ensure that markets operate competitively and transparently, with regard to the interests of consumers. They are not responsible for promoting social equity per se. However, in supervising social tariffs/bill reduction schemes and in protecting groups of consumers from unfair treatment by the market, they cannot ignore the distributional impact of market outcomes. The role and scope of regulation is constantly being re-evaluated. For credit and other financial services, the new Financial Conduct Authority (FCA) can supervise companies more closely. In the energy sector, Ofgem is also adopting, in parallel with the UK Government, new methods of intervening in markets to avoid consumer detriment.

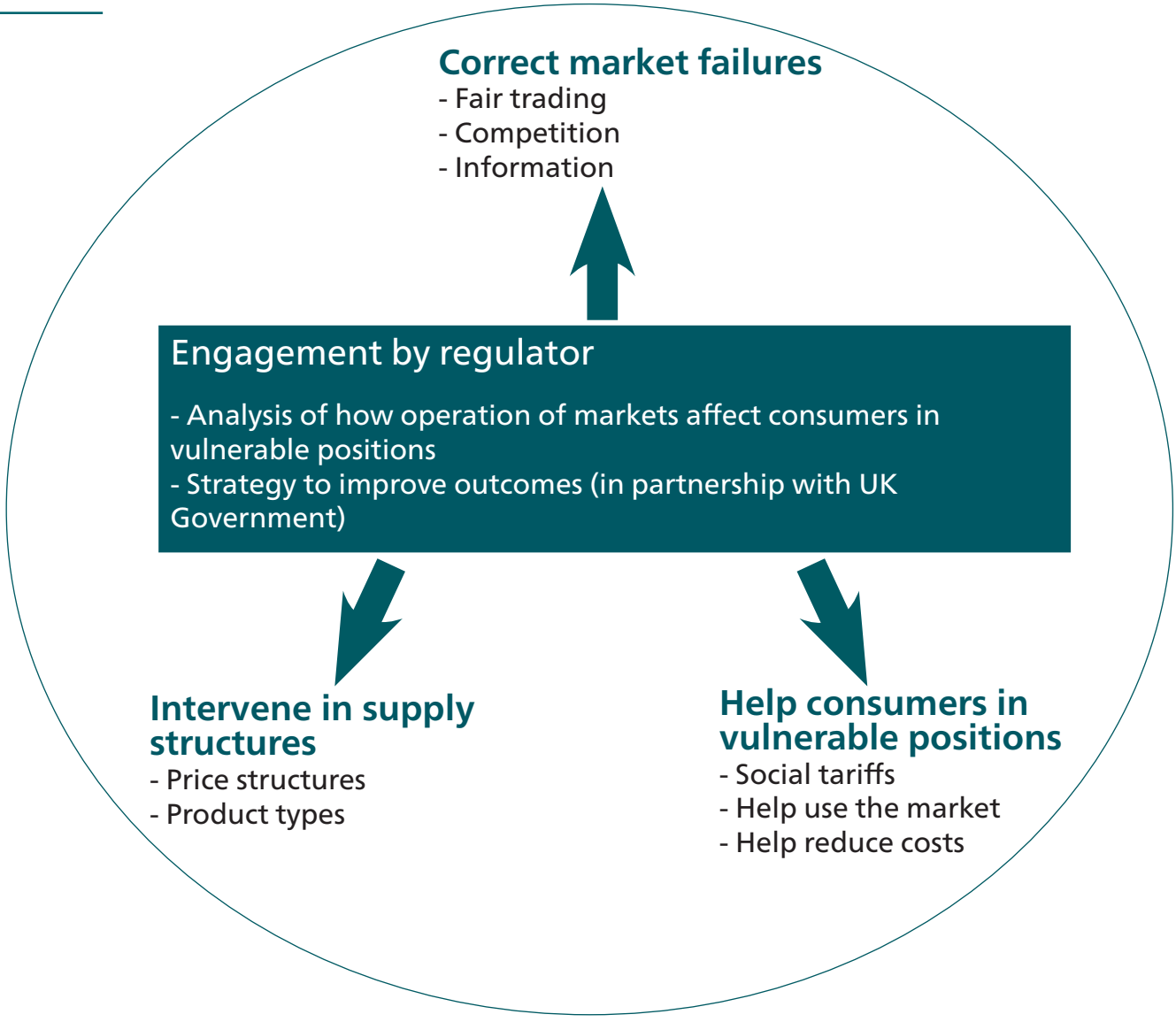
The proposed Consumer Bill of Rights and the promotion of a new British Standard relating to consumer treatment (BS18477) could be interpreted to suggest improved forms of protection, especially for consumers in vulnerable positions.

A framework for regulatory responses

'Regulators need not to be constrained by their existing regulatory powers when investigating whether low income consumers are suffering detriment'

Regulation and wider government interventions can, broadly, operate on three levels, as illustrated in the diagram below. One is to ensure fair trading and promote competition, with adequate information for the consumer: this is the central role of regulators. Another is to go further by intervening in product and pricing structures, where this is deemed necessary to avoid undesirable outcomes of markets. Post-privatisation, regulators of essential services have accepted the need at least to monitor whether outcomes serve the public interest. Thirdly, regulators or governments can give direct help to consumers in vulnerable positions, either in using the market or compensating them for its outcomes, for example by deciding some consumers are eligible for social tariffs/bill reduction, and who will receive them.

Three types of intervention



'...the weak market postion of those on low incomes… might influence any justification for moving from a regime based largely on providing consumers with good information to one that intervenes more directly...'

The framework for intervention in each sector needs to be based on well-informed analysis of risks to consumers, including the special risks arising from those on low incomes. Regulators need not to be constrained by their existing regulatory powers when investigating whether low income consumers are suffering detriment, which might create a case for extending these powers. In particular, regulators should examine whether:

- their actions to protect consumers take adequate account of the weak market position of those on low incomes and in vulnerable positions. In particular, this might influence any justification for moving from a regime based largely on providing consumers with good information to one that intervenes more directly supervising suppliers' behaviours, their products and their pricing.
- there is adequate access to simple low-cost products that make access to utilities including telecommunications affordable. The concept of a universal service obligation in telephony has not been updated since mobile phones and the internet became an essential part of daily life. There is a case for regulators to examine whether they should help ensure that low-cost no-frills access to such essentials is accessible through basic products with stable features.

Conclusion and recommendations

'...poverty premium' is neither a uniform phenomenon nor one that is treated with equal importance in each regulated sector.

The 'poverty premium' is neither a uniform phenomenon nor one that is treated with equal importance in each regulated sector. However, there is clear evidence that people on low incomes are susceptible to paying higher prices for essentials as a result of their weak market power, and that this can have a significant impact on their standard of living.

This report estimates that the poverty premium in the sectors under review can add 10p to costs for every £1 spent overall by low income households. This impact is sufficiently severe for all regulators to take the issue seriously, by looking closely at whether low income households need extra help to thrive in these markets. Following Ofgem's (2008, 2011a) reviews of behaviours and outcomes in energy markets, and the consequent extension of the scope of regulation, it is clear that better information on this subject can play a valuable part in defining the future roles of regulators.

'This report estimates that the poverty premium in the sectors under review can add 10p to costs for every £1 spent overall by low income households.'

The report recommends that regulators should:

- continue to work to help all consumers have good information about markets and to be active in switching between providers and tariffs
- not assume that such help in being 'active consumers' will provide sufficient protection for disadvantaged groups. Continuous monitoring to check whether people on low incomes are less active should be conducted to consider what further protection is needed
- look closely at whether products used disproportionately by households on low incomes are being fairly priced relative to other products, and in particular at whether price differences can be justified on cost grounds or whether low income consumers are being exploited as a 'captive market'
- investigate the structure and level of pricing where they have justified cause for concern on the above grounds
- work with governments to examine the case for intervention in the structure of the supply of essential services to assure basic products at affordable prices.

1. Background and Introduction

This report considers:

- The extent to which people on low incomes may be paying more than others for essential services as a result of their weak position as consumers in industries subject to public regulation
- The impact that this can have on their living standards
- The potential for regulators to address this aspect of consumer vulnerability.

As part of its brief to promote positive outcomes for consumers, Consumer Futures takes a particular interest in those who are in the most vulnerable positions in the market. Consumer Focus's 2012 report *Tackling consumer vulnerability – An action plan for empowerment*, outlined ideas for empowering consumers in vulnerable positions who face barriers and unfair treatment in markets.

This report seeks to focus more specifically on addressing situations where such vulnerability risks creating a 'poverty premium', in terms of the prices paid for goods and services by people on the lowest incomes. It considers such a premium and responses to it in sectors where existing public regulation has been established in recognition of the need to ensure that markets work properly and in the common interest. The report asks whether such regulation takes sufficient account of the risk and impact of premium prices charged to low income households.

The poverty premium and its significance for living standards on low incomes

'The fundamentals of the consequences of lack of market power among lower income consumers are depressingly familiar today.'

A 'poverty premium' occurs when the detriment to households of having low incomes is compounded by them having to pay more than others for essential goods and services. The concept is nothing new: the refrain 'the poor pay more' has been around for years. Indeed it is nearly half a century since David Caplovitz, an American sociologist and early consumer advocate, coined the phrase (Caplovitz, 1967). He showed how retailers used door-to-door sales techniques and hire purchase agreements to extract profits from lower-income consumers whose options and opportunities for price comparison were limited. The fundamentals of the consequences of lack of market power among lower income consumers are depressingly familiar.

However, there are various reasons why the poverty premium is of particular relevance in Britain today.

'...the minimum cost of living is rising significantly faster than general incomes'

First, the minimum cost of living is rising significantly faster than general incomes (Davis et al, 2012). The price that low-income households pay for essentials can contribute significantly to the 'squeeze' on their living standards, increasing the risk of material hardship.

The Minimum Income Standard (MIS), research carried out by Loughborough University's Centre for Research in Social Policy for the Joseph Rowntree Foundation (see Box 1). found, that over the past decade, the minimum cost of living has risen substantially faster than average prices, and living standards for low income families stopped rising well before those of the average household (Hirsch, Plunkett and Beckhelling, 2011). Price has become a key factor in determining poverty and hardship.

Box 1 – The Minimum Income Standard (MIS)

'A Minimum Income Standard for the United Kingdom' is a research programme looking regularly at how much different households need to afford a minimum acceptable standard of living. Funded by the Joseph Rowntree Foundation and conducted by the Centre for Research in Social Policy at Loughborough University, the research involves members of the public in groups looking in detail at what goods and services households need to be able to afford in order to achieve such a living standard, defined not just in terms of meeting physical needs but also having the choices and opportunities required to participate in society. This produces costed budget lists, to show total income requirements. The research is also useful for the present report in identifying which items can be considered necessities, according to social consensus. The research is described at www.minimumincomestandard.org

'Price has become a key factor in determining poverty and hardship.'

Another way in which the poverty premium has particular relevance in the UK today is that some underlying changes over the past 20 or so years have widened overall exposure to poverty premiums. These involve in particular an increase in complexity both in the ways in which households buy packages of essential services and in the ways in which they manage money.

The first change is in the way households access utilities. Utilities provide an essential foundation to an acceptable living standard. The present paper treats not just water and power but also a range of telecommunications services as utilities in this respect. Just as telephones have for many years been considered utilities because they are essential services, mobile telephone and the internet are now relied on for people to conduct life's essential activities.

'...some underlying changes over the past 20 or so years have widened overall exposure to poverty premiums.'

In research on the MIS, mobile phones have been accepted as essential for all households since the first such study in 2008, as has a broadband connection for every non-pensioner household since 2010 (Davis et al, 2010).

There is not yet a consensus among pensioners in the MIS research that the internet is essential, and this corresponds with previous evidence from Consumer Focus (Consumer Focus 2010b) shown that many pensioners do not recognise the benefits of being online.

Before utilities were privatised, they were supplied in relatively standardised ways by the state. Today, they are supplied in more complex packages by competing companies. In some cases this has brought the benefit of lower prices, but privatisation has also brought considerable complexities to utility supply, and in particular has required householders to become 'active consumers' in order to optimise outcomes.

People on low incomes are not always best positioned to take advantage of such markets, and at worst are vulnerable to exploitation. Moreover, well-functioning markets should not restrict the benefits of competition to those who are 'active' consumers at the expense of other consumers: in a street market, as long as some price-sensitive consumers move from stall to stall to find the best bargain, everybody gains from the competition, but a market where prices are only competitive for a minority of buyers cannot be said to be working well.

The experience of managing money has also changed greatly from a time when many people on low incomes were paid in cash and managing a budget meant making money last until the end of the week. Today, 95 per cent of adults have credit or debit cards.[1] Use of credit is nothing new (and hire purchase was part of the poverty premium described by Caplovitz in the 1960s, as described above), but it plays a far more important part in household finances than in the past, having more than tripled in value in 20 years.[2]

Changing methods of payment and wider use of credit are used to help manage the flow of money in lives that require many 'lumpy' purchases and income flows. While both credit and a wider range of payment options can bring benefits to households, they can also bring substantial costs to those on low incomes, either because they face additional transaction charges or because they pay large amounts for credit.

[1] http://bit.ly/10KEDkX
[2] http://bit.ly/Y7UBnr

Moreover, some aspects of financial management by people on low incomes can be adversely affected by the costs imposed by the suppliers of utilities for example, payment methods – like prepayment meters (PPMs) or paying bills quarterly – best suit the lives of people on low incomes are subjected to higher charges.

The poverty premium and regulation

'...consumers may need new forms of protection in a more risky and complex world'

Any attempt to reduce the poverty premium needs to consider its underlying causes. As a starting point, it is important to recognise that the poverty premium can relate, in part, to genuine additional costs associated with serving low income groups. For example, people unable to access goods or services online or at out-of-town supermarkets may miss out on lower prices associated with the lower supply costs of those retail methods.

On the other hand, the prices paid for goods and services can also be linked to the ways in which different groups of consumers can interact with the market, with those on low incomes often in a weak position, for example because of limited information or flexibility that makes them less likely to 'shop around' effectively. In some such cases, these two causes can interact: additional supply costs may partly but not fully explain the premium. Where prices end up higher than they would be in a truly competitive market, issues of competition and regulation arise.

This report explores the ways in which a poverty premium can create special challenges for those who regulate the supply of essential services, and how they might respond.

It could be argued that any poverty premium is not a regulatory issue as such. Where it arises from additional costs in serving low income consumers, this could be addressed either by improving the capabilities of those consumers (eg by though online access) or by improving their incomes, rather than any regulation of providers. Where it arises from market failures, those failures could be addressed through normal regulation designed to protect all consumers, not just poorer ones.

'...people on low incomes have found it difficult to pursue their interests effectively in these markets...'

However, there are two main reasons for regulators to consider this issue.

One is that consumers may need new forms of protection in a more risky and complex world – created by a proliferation of providers of basic services and of the financial and technological means of buying goods and services. These changes are not automatically addressed by the regulatory environment, which tends to react to problems as they arise, rather than taking account proactively of social and technological change.

'...a combination of these factors can make a substantial difference to the standard of living of a low income family.'

The other is that people on low incomes have found it difficult to pursue their interests effectively in these markets, for a variety of reasons, including their lack of financial flexibility and in some cases a lack of real competition in providing products particular to their requirements. Without a deliberate focus on making markets work for these groups, they will continue to be at risk.

Moreover, a combination of these factors can make a substantial difference to the standard of living of a low income family, not just cause them to be slightly better or worse off. This raises wider issues for governments in tackling poverty, as well as for regulators themselves.

The next chapter of this report categorises briefly, ways in which people on low incomes can pay more for utilities and financial services. Chapter 3 explores the overall impact of such premiums on poorer households' living standards. Chapter 4 then looks more closely at evidence of the poverty premium, using a typology that distinguishes different sources of the problem. Chapter 5 considers types of intervention, the role that regulators can play and a selection of ways in which they might consider taking account of the poverty premium in their future work. Chapter 6 concludes.

Box 2: Which types of goods and services are covered by this report and why

The analysis in this report is limited to the poverty premium in certain sectors affected by public regulation: utilities, communications – including mobile telephones and broadband internet – and financial services.

Poverty premiums can also exist in other essential goods and services. For example, a low income family without a car may have to pay more for food and other essential goods at a local shop than at an out-of-town supermarket that they are unable to get to. Transport can itself be more expensive per mile for someone carrying out only a basic amount of travel, whether because of high per-mile cost of short public transport journeys or the high fixed costs of car ownership.

'...where the UK Government has seen fit to regulate an industry, is this regulation taking due account of potential price disadvantages for low income groups?'

However, the focus here is on where low income groups are put in vulnerable positions by unfair treatment by markets, and where general risks to consumers in those markets have already caused a regulatory regime to be established. In other words, the report asks: where the UK Government has seen fit to regulate an industry, is this regulation taking due account of potential price disadvantages for low income groups? The main sectors that meet this criterion are utilities and financial services including credit. (Transport could potentially qualify, since it is partially regulated, but is not looked at here because there is no evident way in which low income groups are being charged more for the same product. For example, anyone who needs a bus pass to meet basic travel needs will pay the same standard price.) This coverage is not, however, as limited as it might first appear. Utilities, including communications, together with finance play an important overall role in allowing people to afford the essentials of life. Where someone pays more, say for household's goods, this is often linked to the way in which they are bought, in which communications (internet access) and financial capabilities (access to credit and to various payment methods) play an essential part. In other words, utilities and finance between them form a central foundation of household spending, required to meet essential needs.

In most respects, including the MIS research and most of the regulatory activity referred to, this report covers the whole of the UK. The exception is the water industry and legislation, where the coverage of the report applies to Ofwat and to water supply in Ofwat's jusrisdiction – England and Wales. In Scotland and in Northern Ireland, water supply is delivered by public corporations, and the issues in this report around regulation of private industries do not apply. Consumer Futures will publish a separate report covering water and sewerage affordability issues in Scotland in autumn 2013.

2. Four types of poverty premium

Various attempts to document the 'poverty premium' (notably Family Action and Save the Children, 2007; Save the Children, 2011; Church Action on Poverty, 2010) have demonstrated a range of cases where many low income households pay more than the norm for essential goods and services. Save the Children (2011) identified a range of items that could add a total of about £100 a month to the budget of a low income family. These are listed in Table 1.

Table 1 – Save the Children illustration of poverty premium

	Typical costs	Costs to low income families	Reason for higher cost	Difference
Basic household item: cooker	£239	£669	Bought on high interest loan	£430.24
Loan for £500	£500	£750	Doorstep lender rather than short-term loan on paid off quickly with negligible interest	£250
Cash 3 x £200 cheques	£0	£36	No bank account	£36
Annual gas and electricity bill	£881	£1,134	Poor value tariff using prepayment meter	£253
Home contents insurance	£67	£99	More expensive insurance area	£32
Car insurance	£310	£598	Ditto	£288

Source: Save the Children (2011). Prices are for late 2010

'...the overall impact on low income households requires a more systematic understanding of how they combine to affect the cost of living

Such lists help show that a poverty premium can affect costs for low income families in a range of areas. However, the overall impact on low income households requires a more systematic understanding of how they combine to affect the cost of living. Moreover, since the specific cases of the premium change constantly with price structures and technologies, it is important to understand what underlying factors are driving higher prices for low income households and, therefore, how they might be addressed.

2.1 Households on low incomes can end up on utility tariffs that cost more than average for consumption

The complexity of tariffs, and the resulting differences in what consumers pay, have been at the forefront of debates about utility markets in recent years. The UK Government and Ofgem are now committed, for example, to simplification and to ensuring that households do not pay more than they need to.

We can distinguish two broad ways in which low income consumers might end up paying more:

(i) *Higher charges by payment method*
Example: Ofgem (2008) found that those on PPMs paid on average £125 a year more, and high-consumption customers £170 more than if they were on Direct Debit, even though the additional 'supply cost' for prepayment customers was only £88. That difference was subsequently greatly reduced, under new regulations requiring companies to show how any tariff difference reflects additional costs.

(ii) *The failure of consumers to be on the best tariff available for a given payment method*
Example: A large number of households that could benefit from switching to water metering do not do so, and this contributes to the prevalence of water poverty (defined as spending more than 3 per cent of income on water charges), especially among single-adult households (Ofwat, 2011).

2.2 Households on low incomes who have relatively low consumption of utilities can pay more on average per unit consumed

For any utility, pricing involves some combination of fixed charges and charges per unit consumed, reflecting the fact that suppliers face fixed infrastructure costs and the cost of supplying an additional unit. Some utilities such as broadband internet and unmetered water have fixed fees for unlimited usage, while others such as energy supply have moved away from standing charges, but still generally charge more at the margin for the first tranche of use than for high usage. Many considerations, different in each sector, influence this balance. A general observation is that those on low income with low usage do relatively worse from a system with greater emphasis on fixed rather than per-unit charges.

Example: The ways in which households pay for fixed-line telephone services has changed in recent years. Traditionally, the main payment is a charge per minute, on top of a small standing charge. Today, per-minute call costs have gone down, with packages typically comprising mainly fixed charges which in some cases include unlimited free calls to landlines and even, mobile phones. The latest survey by telecoms regulator Ofcom shows that among the half of households who continue to buy fixed-line telephone services separately rather than as part of a 'bundle', the cost of doing so varies relatively little according to usage. For example, a 'basket' of telephone usage typical of a low income retired couple using 223 minutes a month costs only 7 per cent less than a basket for a 'networked family' using 593 minutes – a gap that has continued to narrow in recent years (Ofcom, 2012, page 89).

2.3 Households pay additional charges or higher prices because of the way they carry out transactions

Another type of poverty premium results from the different ways in which people on low incomes purchase goods and services. Part of this relates to the way they make financial transactions. In particular, people with limited flexibility in terms of cash flow often dislike payment methods like Direct Debits which reduce their control over the timing of payments and can lead to bank charges if they get into debt. Another important aspect of transactions today is whether they are carried out online. Both of these features can be associated with different prices and charging structures, most directly where suppliers give discounts based on payment method or charge different prices to online customers for precisely the same product. Consumers who are sent bills are often charged more than those who view payments online.

Example: Those who lack access to the internet are unable to access the best prices for goods and services. One aspect of this is price comparison; another is discounts for buying online. In 2008, it was estimated that a household on an average income saved about £70 a month from having broadband in the home, while a household in the lowest 10 per cent of incomes (who buys less overall) still saved £23 a month (SQW Consulting 2008). Low income households who are not online are unable to access such benefits. Since this estimate has been made, savings from being online become ever more pervasive; for example, utility companies and banks are introducing fees for continuing to send paper bills.

2.4 Low income households can pay very high interest rates on loans to buy basic household goods and other necessities

Borrowing money can be an important part of maintaining an acceptable standard of living. As well as helping to smooth over periods of variable income, it commonly assists households in buying larger durable goods and making other 'lumpy' purchases. Although taking on debt on a low income can carry severe risk in terms of ability to repay, responsible borrowing and lending can have an overall positive impact on living standards.

However, the cost of borrowing for low income households is sometimes extremely high. Three types of credit – payday loans, rent-to-own buying and doorstep lending have come under scrutiny because of the high effective interest rates that they sometimes charge. While these might in part reflect a relatively high risk of default among groups who often find it hard to borrow from mainstream lenders, it is also clear that the high interest rates often over-compensate for such risks to yield high profits (Competition Commission 2006, Office of Fair Trading (OFT), 2010).

Example: In 2012 the National Audit Office (NAO) estimated that 'unscrupulous behaviour by firms in this [the consumer credit] market cost consumers at least £450 million in 2010-11, with the most vulnerable consumers potentially most at risk.' This estimate is based on analysis of consumer complaints and only covers direct financial harm. The NAO points out that high-cost credit is the fastest-growing sector of the market, and its consumers have, overall, 'Lower than average understanding, lower than average incomes and poor credit ratings or no credit history.'

3. Impact of the poverty premium on living standards of low income households

The previous Chapter set out different forms of the poverty premium. But how great is its overall magnitude? Not all households on low income experience every kind of poverty premium, so adding up every example would not give a valid estimate of the detriment suffered by an individual household. Rather, the following calculations help quantify the damage by considering the combined effect of two particularly common, clear-cut and costly aspects on minimum household budgets as represented by the MIS.

The two aspects of additional costs assumed in these calculations are:

a) **Higher tariffs for the main utilities – power, water and telecommunications (landlines, mobile phones and internet) – faced by low income families who fail to get the best deals.** This can come both from payment method and from choice of supplier and/or package (see Box 3). The MIS budgets assume, as a starting point, that households find a competitive tariff. However, in reality, low income households are often not on an optimum payment package.

Box 3 – Why low income households can pay higher tariffs

The evidence shows clearly that low income consumers are vulnerable to paying higher charges for utilities, in two main forms:

(i) Higher charges by payment method. Ofgem (2008) found that those on PPMs paid on average £125 a year more, and high-consumption customers £170 more than if they were on Direct Debit, even though the additional 'supply cost' for prepayment customers was only £88. That difference was subsequently greatly reduced. Prepayment customers now pay a similar amount to those on 'standard credit' (Ofgem, 2011a), although still above Direct Debit at a level that may broadly reflect the difference in supplier cost.

There have been some general similarities to this pattern in the payment method for mobile phones. Pay-as-you-go (PAYG) charges tend to be higher per unit than contracts. This picture has varied over time. Save the Children's first (2007) poverty premium report estimated a 22 per cent premium on using PAYG, but in its second report covering late 2010, it noted that mobile phone prices had gone down generally. More recently, Ofcom (2012, pp94-95) noted that the main PAYG rates were going up, while high-use deals continue to go down.

(continued overleaf)

Box 3 (continued)

As well as the de facto observation that low income households are far more likely than others to use PPMs and PAYG telephones, this payment pattern corresponds to what often suits households managing on a low budget (Church Action on Poverty 2011). Direct Debits and monthly contracts can give less control over cash flow, and in the case of energy charges based on estimated usage can cause households to run up arrears that become difficult to clear.

(ii) The failure of consumers to be on the best tariff available for a given payment method. Whether this occurs can depend both on the extent to which consumers are active in searching for the best price and on their ability to find the best price when they do. There is evidence that people on low incomes fare poorly on both counts. For example, Ofgem (2008) found that nearly half of PPM customers who switched did not receive a saving and classified only 17 per cent of energy consumers as 'active' consumers, who at that time did not just switch but compared prices. Low income groups are more likely to switch as a result of sales activity, less likely to access cheap online deals, more likely to be prevented from switching because of arrears (Ofgem 2008). They are also more likely to be among the 40-60 per cent of households classified as 'sticky' customers (non-switchers), often ending up on high 'legacy' tariffs (Ofgem 2012a). This last phenomenon has not been accidental but part of a cross-subsidy that allows companies to offer lower tariffs to attract new customers from among more active consumers (Ofgem 2012b), and thus a systematic transfer from a less active, and on average lower-income, group to a more active and higher-income group.

These factors affecting choice of tariff by low income groups result from a combination of behavioural attributes and imperfect knowledge or understanding. In the water industry, there is a concern that similar factors make it more likely that low income households end up on tariffs that are too high (see Box 4).

Box 4 – Water charges: metering and the poverty premium

The water industry in England and Wales, regulated by Ofwat, has important differences as a privatised utility from others reviewed in this report. (In Scotland and Northern Ireland, water services are delivered by public corporations.) The most important is that each area is supplied by a local monopoly company, which as a consequence has its prices closely supervised by the regulator. Yet within this framework, issues still arise about the fairness of pricing structures, in terms of how they affect users on different incomes.

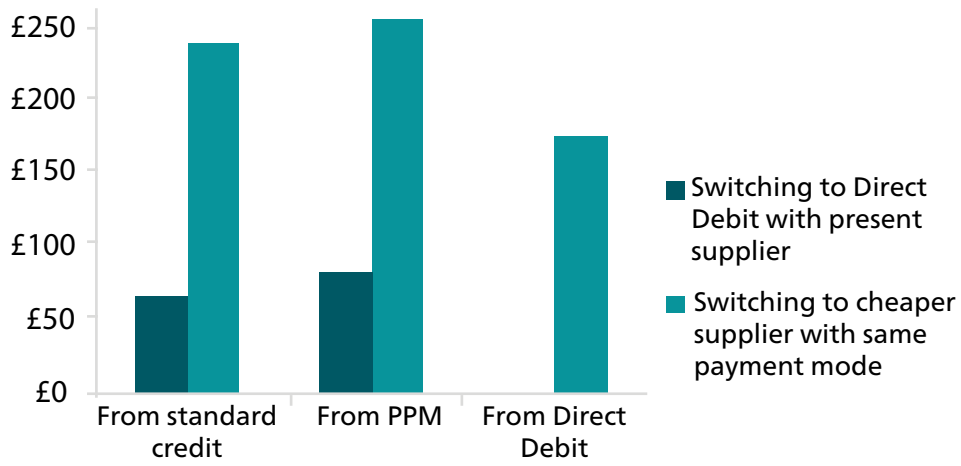
The most significant current issue is whether homes are metered or pay flat-rate charges, with the Environment Agency and Ofwat encouraging a move from the latter to the former, but with suppliers giving households a choice over such a switch. Other things being equal, the sharing of costs between two households of the same size but different incomes should in theory produce a more favourable result for those on low incomes on a metered regime than with a fixed tariff based on average costs. This is because more affluent households typically use more water as a result of owning items such as dishwashers and garden hoses. However, not all low income families have below-average usage, and larger families, with relatively high usage, are more likely to be on low incomes. The situation is further complicated by the fact that as more low-use consumers switch to metering, the price of fixed tariffs rises, since it is based on the average cost of supplying those remaining on the fixed regime.

While this produces no single answer to 'what kind of tariff is best for low income households', one commonality with other sectors is the difficulty in relying on well-informed consumer behaviour to produce optimal outcomes, especially for the worst off. A large number of households that could benefit from switching to water metering do not do so, and this appears to contribute to the prevalence of water poverty, especially among single-adult households (Ofwat, 2011). As in other sectors, this contributes to a cross-subsidy from a less active and on average worse-off group to a more active and on average better-off group. The more that active consumers who can benefit switch to metering, the more these inactive groups lose out, since the average cost of unmetered supply and hence its price continues to rise.

How much difference can the combination of these two effects, payment type and tariff structure, make to household utility bills overall?

Two pieces of evidence in the energy sector suggest that the magnitude is important to the living standards of households in or on the brink of poverty. First, the Hills review of fuel poverty estimated that among households with the lowest 30 per cent of incomes, fuel poverty would have been 15 per cent lower in 2009 if they had paid the lowest tariffs but 7 per cent higher if they had paid the highest ones (Hills, 2011). Second, Figure 1 below suggests that the benefit of switching supplier can be worth a lot more than the benefit of switching payment mode (this calculation was done after the PPM premium had been cut substantially). The savings from switching supplier, to the cheapest standard tariff, amounted to roughly 20 per cent of an average bill in 2010. As shown in Figure 1, even at a time when there were significant differences by payment method (which have since reduced), it was switching supplier that created the greater savings.

Figure 1 Average savings from switching dual fuel energy bill, 2010



Spending on an average dual fuel offline Direct Debit tariff in 2010 was close to £1,000. Source: Ofgem 2011a

We can sum up this evidence by saying that people on low incomes are in vulnerable positions from paying higher than necessary utility tariffs

We can sum up this evidence by saying that people on low incomes are in vulnerable positions from paying higher than necessary utility tariffs, and that these can add up to 20 per cent to the 'optimal' utility bills assumed when calculating the cost of a minimum budget in the MIS research.

b) The use of high cost credit to purchase larger household goods and other long-term items

A second measurable premium is the difference between interest paid on mainstream credit and interest paid on the very high-cost credit that many low income families use to make these purchases. The poverty premium associated with high-cost credit has a pervasive effect because it can be felt across a wide range of household purchases. In particular, buying goods from rent-to-own catalogues where the eventual amount spent is far higher than a one-off purchase in a shop or online, puts consumers in a different, more expensive shopping market than people paying up front for the same goods.

Box 5 summarises recent research estimating the overall cost of such credit to households using it to buy more costly durable goods indentified in MIS as being needed for a minimum living standard.

Box 5 – adding up the cost of high-interest credit on household budgets

The Centre for Responsible Credit has looked across the board at the impact of paying for a minimum basket of goods and services using high interest rates (Gibbons et al, 2011). Looking at those items in the MIS basket that are relatively costly and bought relatively infrequently (and thus might be bought on credit), it compares the cost of buying such goods on mainstream and on very high cost credit. It finds that buying essential items by this method can significantly reduce the living standards of people on low incomes. For example, for a single person buying a minimum basket of goods and services costing on average £140 a week in 2011, it was estimated that about £22 would be for items bought on credit, and the additional cost of paying high rather than low interest on this credit would be of the order of £10 a week. Detailed figures from this study are used in the calculations below.

Estimating the combined premium

How much do these two premiums, high utility tariffs and high-interest borrowing, contribute to the minimum cost of living? The total weekly cost of utilities in MIS budgets is higher than the cost of items assumed to be bought on credit: £27 and £23 a week respectively for a single person. However, the latter contribute more to the poverty premium because the percentage premium that households pay is greater – sometimes as much as half the cost of the item in additional interest, rather than the 20 per cent extra assumed for utilities.

'...between a fifth and a third of all outgoings in these scenarios are utility bills or items typically bought on high cost credit, and thus potentially exposed to a poverty premium.'

The calculations below also distinguish a high and a low model of fuel use. The MIS budgets assume that families live in well insulated social housing, where energy use is relatively low. Low income families who live in harder to heat homes suffer more in absolute terms when they pay more for their fuel because of their tariffs, and this additional impact is factored into the high energy use calculations. The high fuel cost scenario assumes that fuel consumption is double that assumed in MIS. This corresponds approximately with the ratio of costs between homes with the energy rating assumed in MIS and the least efficient category of home. [3]

Figure 2 shows calculations of the scale of the poverty premium based on the criteria above, both for households with relatively high and with relatively low heating costs. Altogether between a fifth and a third of all outgoings in these scenarios are utility bills or items typically bought on high cost credit, and thus potentially exposed to a poverty premium. The premium itself can add up to around 10 per cent of all household costs. Assuming higher heating costs adds to the proportion of the budget exposed to the premium by about 5 per cent, but since it is assumed that higher tariffs add 20 per cent to the cost of fuel, it makes a difference of about 1 per cent to the poverty premium.

[3] The homes on which MIS energy costs are based have a 'D' energy rating. Just over half of low income households live in homes with this rating or better, but 14 per cent live in homes with an F or G rating (Hills, 2012 page 74). On average F/G homes cost roughly twice as much to heat as D homes (estimated from Hills, 2011 page 39).

Figure 2a Estimated scale of poverty premium by household type, assuming low fuel consumption

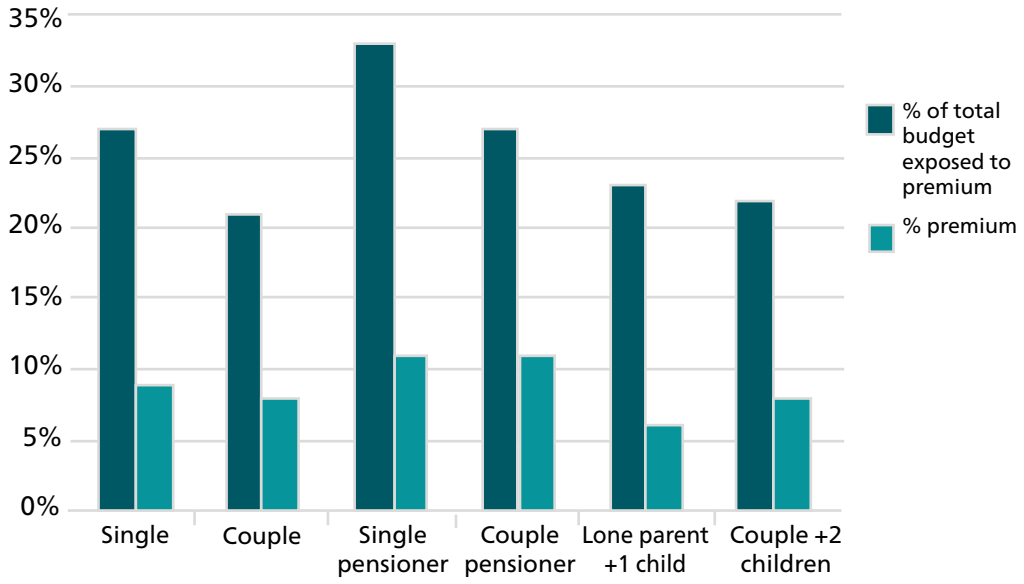


Figure 2b Estimated scale of poverty premium by household type, assuming high fuel consumption

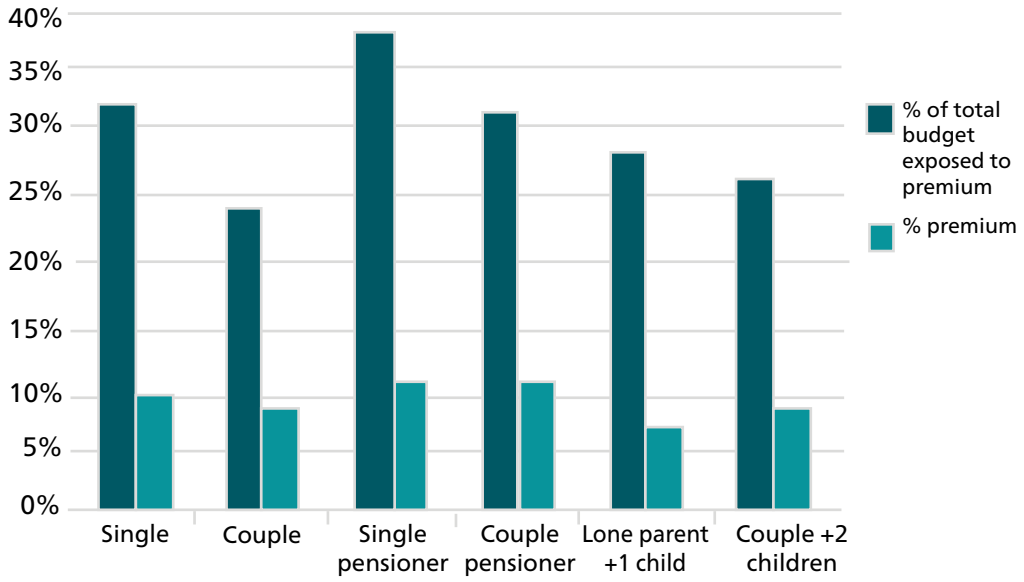


Figure 2 shows up two important findings:

a) Single-adult households and pensioners are in particularly vulnerable situations. This is because every household needs certain core essentials, such as a refrigerator and a broadband connection, and these comprise proportionately more of smaller households' costs. In addition, pensioners have relatively higher fuel costs. Pensioners' core household goods are a similar price to the same sized working age households, but they require less spending on some other items including food (according to pensioners' own specifications), so the cost of using high cost credit to buy household items is larger relative to their overall budget.

b) These two areas of spending between them comprise a very significant part of the budget of a low income household. For example a single person spends about 27 per cent of a standard MIS budget on food, 15 per cent on utilities and 13 per cent on the items that might be bought on credit, so that even in this low fuel-use model, the amount of spending exposed to the poverty premium is similar in size to the whole food budget

Thus, a substantial proportion of household spending is exposed to the poverty premium, which can cause the minimum cost of living to rise significantly.

But for someone on a low income, what is the impact on the ability to afford the essentials? This clearly depends on income level. Figure 3 considers the case of someone working full time on the minimum wage, who cannot reach a minimum acceptable standard of living even without a poverty premium. It shows that having to pay more for items extends this shortfall further. Having high fuel costs extends it further still (the difference that this makes as shown in Figures 3 to 5 combines the effects of higher fuel consumption itself and a higher price per unit).

Figure 4 then shows the disposable income (after taxes, and housing costs) of a single person in different income scenarios, compared to their required income. Comparison of the first two bars in each case (ie the difference between income and requirements before any poverty premium) illustrates the contrast between people not working and on low wages.

A person relying on out of work benefits has only 39 per cent of what they need for a minimum acceptable living standard, someone on the minimum wage is still substantially short (with 71 per cent) and someone earning a third more than the minimum wage (£8.12 an hour) – roughly the 'living wage' level – has almost enough. In each of these three examples, the poverty premium and high fuel costs raise spending requirements, so actual net income becomes less adequate relative to need.

Figure 3 How far a single person on minimum wage falls short of minimum budget (illustration)

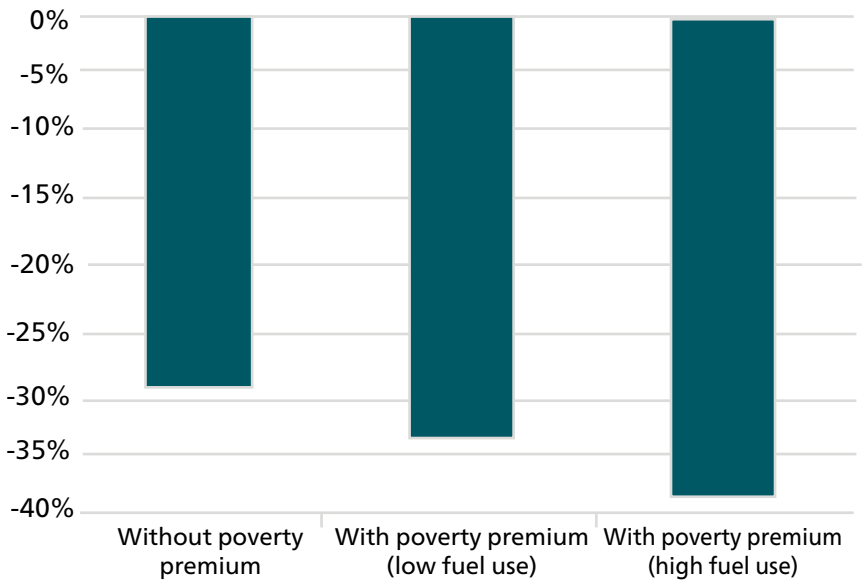
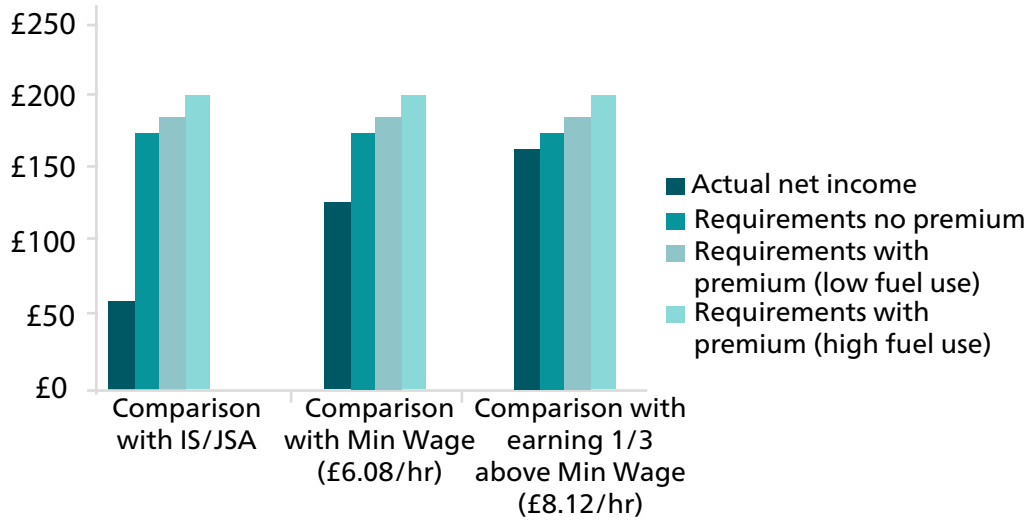


Figure 4 Income and requirements of single person on low income, in and out of work



(£ per week April 2012. Source: MIS data)

The differences are substantial, although less significant than the difference between not working, working on the Minimum Wage, and working at a wage one-third higher For example, even without the poverty premium, the shortfall more than halves from £110 to £52 a week as a result of moving from out-of-work benefits to the Minimum Wage, and falls to just £9 if earning a third above the Minimum Wage. In each of these cases, a poverty premium combined with high fuel usage would add £25 onto this shortfall.

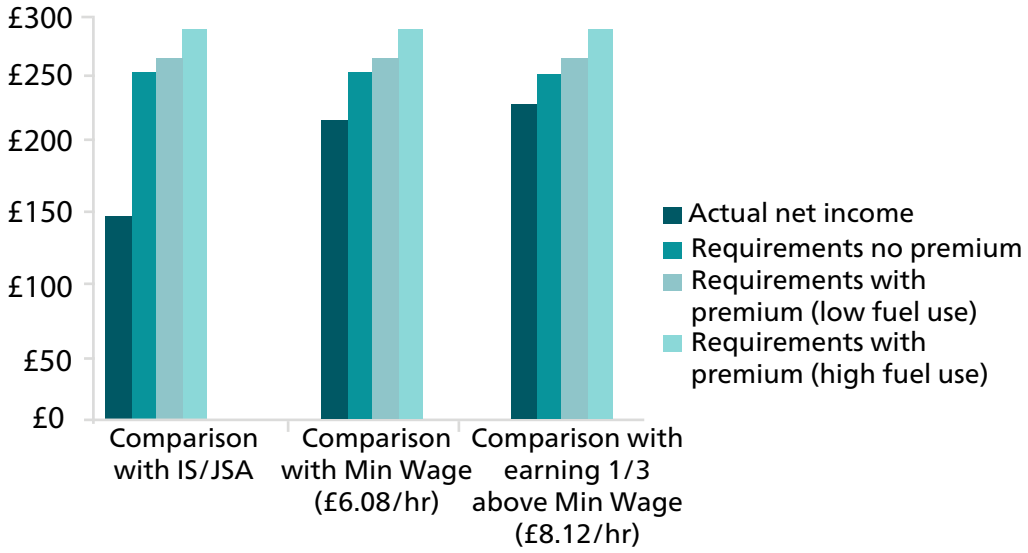
'...for a working lone parent, variations in living standards due to costs can be much more important than variations due to earnings.'

However, for families with children, the situation is a bit different. The state gives families with children more support, relative to their needs, than those without, whether they are in or out of work. However, as earnings rise, this support is withdrawn quite sharply. (This is true because of the loss of tax credits, and will continue to be true under Universal Credit, which will also be withdrawn rapidly as earnings rise.)

The result, seen most clearly in the case of a lone parent family as illustrated in Figure 5, is that there is a smaller difference in net income in the three scenarios illustrated, and in particular between the two work scenarios. The state effectively guarantees a certain level of income to working families, even on very low earnings, and this is not very far below the minimum required. The poverty premium undermines this guarantee, by increasing by a large proportion the amount that a working family may fall short of an acceptable living standard.

In the example in Figure 5, the shortfall reduces from £108 to £31 as a result of a lone parent entering work on the minimum wage (full time), but only by a further £5 to £26 if the wage increases to a third above minimum. The poverty premium combined with higher heating costs increases the shortfall in each case by £38. Thus for a working lone parent, variations in living standards due to costs can be much more important than variations due to earnings.

Figure 5 Income and requirements of lone parent with one child on low income, in and out of work



In summary, the above analysis shows that services subject to public regulation can comprise between a fifth and a third of an essential budget, and that paying high prices for these items can add around 10 per cent to overall living costs. For a household already falling short of what they need, this effect compounds greatly the detriment of having too low an income for a minimum acceptable living standard.

'...lower-income households with 'inflation-only' increases in their income, based on CPI, would see a fall in their living standard.'

Moreover, the poverty premium effect interacts with trends in prices that have been working against low income households, caused by the overall pattern of their spending. Over the past decade, the prices of food, public transport and of some utilities have risen faster than prices generally. As a result of these items representing higher proportions of a minimum budget than of average household spending, the minimum cost of living has risen faster than the average cost of living. As a consequence, inflation for someone on a minimum income was estimated as 43 per cent between 2001 and 2011, compared to the Consumer Prices Index rise of 28 per cent (Hirsch, 2011). This meant that lower-income households with 'inflation-only' increases in their income, based on CPI, would see a fall in their living standard. In addition, during that period the portion of that income exposed to the poverty premium increased significantly, as a result of the relative increase in the price of two utilities: household fuel (whose price rose by 124 per cent) and water (which rose by 64 per cent). This shows that even before the announcement in 2012 that benefits in the next three years will rise by just 1 per cent, almost certainly more slowly than CPI, the buying power of low incomes was being eroded.

4. Causes, categorisation and implications for intervention

Before we can approach the role of regulation in seeking to limit a poverty premium, we need to be clear about its underlying causes. The premium is not a single phenomenon, but the interaction of a variety of factors, both in the ways in which services are supplied and the position of low income households as consumers.

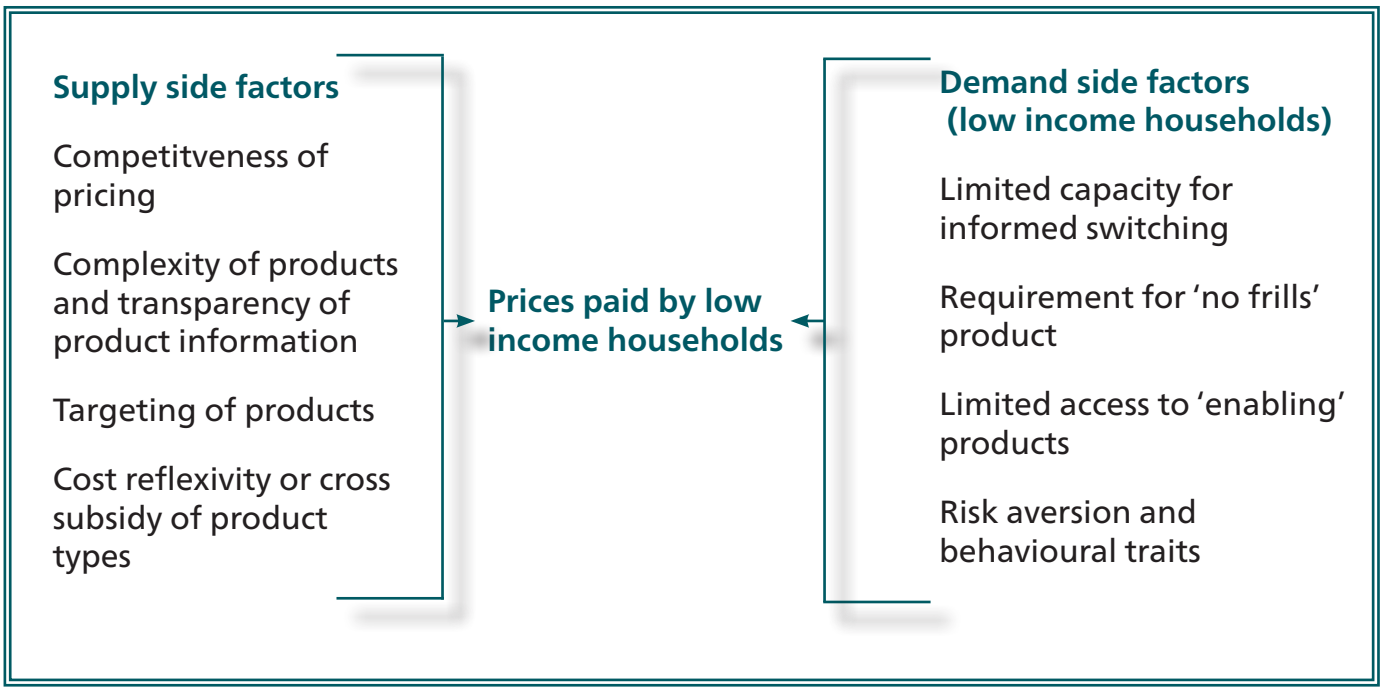
Europe Economics and the New Policy Institute (2010) investigated for the OFT how people on the lowest incomes are treated in a number of case study markets, identifying reasons for various disadvantages that they suffer compared with people on higher incomes. In doing so, they distinguished factors on the demand and supply sides of these markets that contribute to any disadvantage.

'...low income consumers cannot simply be regarded as consumers who are similar to others except with less money to spend.'

Figure 6 illustrates some of these factors that can interact to create a poverty premium. Some of the supply side factors create issues for all households, but can especially affect those on low incomes, as discussed in Chapter 2. Others relate to the extent to which markets create products that suit the requirements of those on low incomes. A particular supply-side issue is the structure of prices charged for different products, and whether price differences accurately reflect cost differences, or rather create a cross-subsidy that could help or harm low income groups.

The demand side can be described in terms of the capacities, behaviours and particular requirements of low income consumers. Fundamental to this analysis is that low income consumers cannot simply be regarded as consumers who are similar to others except with less money to spend. Poverty and low income profoundly affect the context in which people consume. In particular they can limit capacity to take full advantage of what is available in the market, whether by reducing capacity to look around for deals, increasing risk aversion in terms of switching to unknown products or limiting flexibility because of cash flow constraints.

Figure 6 Supply and demand factors influencing the poverty premium



'the interaction of supply and demand can, broadly speaking, create three categories of poverty premium'

The interaction of supply and demand can, broadly speaking, create three categories of poverty premium, in terms of underlying causes:

- **General market failures:** Uncompetitive or unfair practices that hit low income consumers particularly hard
- **Specific market failures:** The failure to supply products that meet the needs of low income groups at competitive prices
- **Additional premiums:** Higher prices or overall costs faced by low income families for reasons that reflect the additional or alleged additional cost of supplying them

These are now considered in turn.

General market failures and the impact on low income consumers

To maximise the benefit to consumers, markets should operate with transparency and without restrictions to competition. Utility regulators have encouraged competition among suppliers, or where it is naturally limited (most notably in water supply) supervised pricing in order to prevent companies from making monopolistic profits. They have also aimed to ensure that pricing structures and other terms of sale are transparent, and that sales practices are not misleading. Where markets work well in these respects, all consumers should benefit.

'...complex tariff structures cause many consumers to have sub-optimal tariffs'.

In practice, the most consistently elusive condition of a well functioning market in the competitive sale of utility services has been the creation of tariff structures that consumers understand, allow them to optimise their purchase decisions and effectively engage in the market. As has been well established by Ofgem (2008, 2011a and 2012b), unnecessarily complex tariff structures cause many consumers to have sub-optimal tariffs, either because they do not shop around for new tariffs or suppliers, or because they make the wrong choices when doing so.

The evidence shows that low income consumers are more likely to suffer from this form of market failure (see Box 3 above). One reason for this is that they are justifiably more risk averse than consumers with more financial leeway when things go wrong. Another reason is their more limited access to information. Moreover, the detriment caused by paying too much for a service tends to be greater in proportion to their income for low income groups.

The existence of this poverty premium that tilts the impact of market imperfections against low income groups has important implications for the case for action to regulate markets.

In particular, as low income consumers are less able to benefit from a competitive market, there is less opportunity for an effective economic transfer of resources from so called 'sticky consumers' to 'active consumers', which can damage those who are worst off. In some markets, such as the market for food, people on low incomes are, if anything, more price sensitive and, therefore, more likely to 'shop around' for the best deals. On the other hand, they find it much harder to do so when buying services such as utilities and financial services.

One suggested reason (Europe Economics and New Policy Institute, 2010) is that such purchases involve less frequent and more complex decisions than food shopping. Unwise decisions are less readily recognised and corrected. Moreover, tariff complexity and differentiation between prices paid by existing and new customers also raises the possibility of charging far lower prices to 'active' than to 'captive' consumers, to a much greater degree than is possible in a supermarket. This means that the existence of a minority of price-sensitive consumers can have less general impact on prices, simply keeping prices low for those consumers at the expense of others. (This is particularly the case if, as tends to be assumed by regulators, the main indicator of an 'active' market is the number of consumers who switch by deals offered to new customers, rather than how many are encouraged not to switch, potentially through deals rewarding loyalty.)

'...this does not necessarily mean that a simple and uniform price structure will always be in the best interest of consumers'.

However, this does not necessarily mean that a simple and uniform price structure will always be in the best interest of consumers, since differentiation may be necessary to stimulate competition. This has created an underlying dilemma in the way gas, electricity and telecommunications services have been sold to consumers since they were privatised. Different companies supplying these services are in general using a common infrastructure to supply a common product, such as electricity flowing through the National Grid, often with similar or identical wholesale costs. A competitive market in selling such services, which creates pressures to lower prices generally, relies to some extent on forms of 'product differentiation' in terms of tariff structures, because of limited opportunities to compete on other criteria such as efficiency in delivery. While one form of market failure is where tariffs are so complex that consumers cannot accurately choose the best one, another form would be if every supplier were providing exactly the same product at an identical price. All consumers, including those on low incomes, could lose out if a lack of effective competition caused prices to be higher generally than they need to be.

Ofgem in its Probe noted:

'Large discounts available through online tariffs are principally driven by acquisition strategies, rather than cost differentials

'Price differentials mean that companies charge more to existing "sticky" customers while maintaining competitiveness in more price sensitive segments of the market.'

Market failures in supply to low income households

As discussed above, households on low incomes may require different kinds of products from the average household. Differences in their requirements may include different:

- types of payment method, which meets their need for maintaining close control over their finances (see Box 5 below)
- patterns of usage, with low-cost low-use products more likely to fit with what such households can afford
- forms of credit, with a greater need for short-term, flexible credit lines outside the normal constraints of bank lending.

'... a central issue is whether higher prices for products used by low income households can be justified.'

Some of these requirements may involve additional costs to suppliers (see below). However, a central issue is whether higher prices for products used by low income households can be justified by or exceed these additional costs. Where they do, the issue arises of whether there is adequate competition in the supply of such services, and if not, whether this results either in excess profits or in a cross-subsidy to non-poor consumers in order to attract them as customers.

A clear-cut example of such market failure is in the supply of high-cost credit. The Competition Commission (2006) found clear evidence that features of the home credit market gave rise to adverse effects on competition and that, as a result, customers paid higher prices than could be expected in a competitive market, yielding profits 'in excess of the typical cost of capital'. Both supply and demand factors contributed to this market failure: on the one hand, the insensitivity of customers to prices and on the other the failure of lenders to compete in any significant way on price, which in turn was caused in large part by the failure in these markets to share information about credit-worthiness and thus the existence of 'captive' customers for those holding such information.

The Office of Fair Trading's referral of the payday lending market to the Competition Commission in 2013 raises a similar set of issues.

The OFT's own review of compliance of the industry with the Consumer Credit Act (Office of Fair Trading 2013), which also drew on Bristol University's research into the prospective impact on credit markets of an interest rate cap (Personal Finance Research Centre, 2013), identified 'deep-rooted problems in how lenders compete with each other', and found that they failed either to assess the affordability of loans to low income households or to give proper information about how payments would be collected.

This evidence shows how seriously markets can fail in terms of proper competition and fair trading when supplying a set of consumers in the highly vulnerable situation of being desparate for cash.

'...in other cases the risks lie in the structure of pricing for a mainstream product'

While high-interest lending is an example of a completely different set of suppliers, separate from 'mainstream' lenders, exploiting the weakness of low income customers to gain excess profits, in other cases the risks lie in the structure of pricing for a mainstream product. Additional charges for PPMs above their additional cost would not, in theory, have been possible with sufficient market competition to supply PPM customers, but in practice the 'stickiness' of those customers enabled suppliers to cross-subsidise sales to those using other payment methods.

Similarly, a competitive market would ensure that low-use electricity, gas or mobile phone customers were not over-charged. One economic study of pricing in the electricity market suggested that in the years following privatisation, the six main suppliers each adopted a different ratio of fixed to marginal charges, in a way that could not be accounted for by costs, and would not be predicted under properly competitive conditions (Davies et al, 2011). This created a segmented market, but one in which each provider had its own niche in terms of tariff structure, reducing competition to provide a similar structure at a lower price.

In telecommunications, a risk of pricing structures that impose additional non cost-reflective charges on captive consumers is increased by the fact that it is very difficult to allocate costs to any one aspect of a service: most costs are for infrastructure and not for an easily specified unit of usage. However, it is clear for example that a substantially higher price for calling certain numbers such as non-geographic numbers is not justified by additional costs in connecting these calls (see below). In the water industry, there is more debate about whether metering or fixed charges more appropriately reflect cost. Some argue that fixed charges are more appropriate because the cost of supply is not proportional to usage. Ultimately a switch to metering disadvantages larger households, with higher consumption. Such households are not necessarily on low income, but families with three or more children have a higher than average risk of being in poverty (DWP 2012).

Box 6 – Low income and financial capabilities

One characteristic of people on low incomes that makes them vulnerable to paying more for a wide range of goods and services is that they often have access to a more limited range of financial tools than better-off households. The proportion of low income households without bank accounts has now fallen sharply, from nearly a quarter in the late 1990s to just 5 per cent a decade later (www.poverty.org.uk), but this could start to reverse as basic bank accounts have come under threat (Consumer Focus 2012). Moreover, access to the banking system is only one aspect of a household's capabilities. Those on low incomes can be subjected to additional charges, either from financial providers themselves, or by other companies selling goods and services that are discounted based on payment method. Reports on the poverty premium have drawn attention to certain high cost transaction services such as for cashing cheques (eg Save the Children 2011). The issue is summarised well at a more general level by Consumer Focus (2011):

'The precariousness of low-income consumers' finances and personal circumstances means that they often have to prioritise control (predictability, without hidden fees or penalty charges), clarity (easy to understand terms and conditions) and convenience (easy access and limited barriers) over long-term cost. Unlike more affluent consumers, they cannot afford to take the risk of the fees and penalty charges for missed payments that come with more mainstream products. Instead, many low-income consumers rely on more expensive payment methods and financial products, such as cash, certain types of credit (eg home-collected credit, payday loans) and prepayment meters (PPMs), which are better suited to their priorities for day-to-day money management.'

Perhaps the most pervasive example of this phenomenon is the reluctance of people on low incomes to use Direct Debits, even though this is generally the most advantageous payment method, due to discounts for using it or fees for payments that do not use it. Direct Debits hand over control over the timing of deductions to the payee rather than the consumer. Retaining this control can be a rational decision for those who plan cashflow precisely, and could face punitive penalty charges if they 'default' on a request for funds. On the other hand, many low income households are obtaining services such as payday loans through a continuous payment authority, which is not subjected to normal Direct Debit regulation, can be presented repeatedly to obtain payment, under terms not always understood by users, and can cause households to have even less control over the flow of money from their accounts (Citizens Advice 2012).

Box 6 (continued)

In a constantly changing financial world, new products are emerging that might help address the needs of people on low incomes, including mobile banking and prepaid stored value cards. These can change people's transaction habits in a short space of time: in the United States, 29 per cent of 'underbanked' people questioned in a recent survey had used mobile payments in the previous 12 months (Federal Reserve, 2012). However, there is always the risk that they come with additional costs, and consumers are in vulnerable positions because they fall outside normal banking regulation. One recent US study found that prepaid cards had 42 different categories of charge, ranging from use of out-of-network ATMs to a 'dormancy' charge for infrequent use, which were not being adequately disclosed to users (Newville, 2012)

Additional costs of supplying low income households

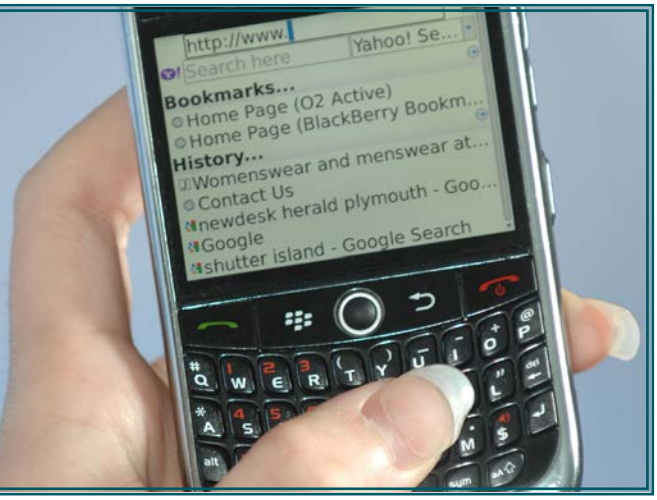
In addition to their weak position as consumers in imperfect markets, low income households may suffer additional costs reflecting the extra cost of supplying them with various services.

In some cases, this relates to disadvantages that they could be helped to overcome. Households who have high energy bills because they cannot afford to improve the energy efficiency of their homes may be helped to do so. Those unable to take advantage of online deals reflecting the lower cost of supplying goods and services in this way may be helped to access the internet.

In other cases, additional supply costs would be harder to address directly. Low income households pay more for insurance if they live in high crime areas because they present a higher risk. This form of poverty premium might better be addressed by reducing crime than by seeking to make insurance companies ignore the cost difference, which would discourage them from taking on clients with certain postcodes.

One challenge in addressing cost reflectivity is ensuring that where additional costs exist, they are not exaggerated when setting price premiums. An obvious example is PPMs for gas and electricity, where companies, following action by the regulator after high profile pressure from Consumer Focus and other groups, have reduced the premium more accurately to reflect the additional cost compared to payment by Direct Debit (Ofgem 2011a).

However, working out what is a genuinely cost-reflective price premium is not always straightforward. In some cases, additional costs may actually interact with pricing policies. For example, where low income households pay very high interest rates on unsecured loans, based partly on a high risk of default, this risk may actually be influenced by the interest rate itself. A high interest rate (or high penalty charges for late payment) can make the loan more expensive to repay, and so increase the default rate. It can also make lenders less likely to look closely at households' ability to repay, knowing that they can still make a healthy profit even if a proportion default.



It can also be difficult to apportion accurately the contribution of high and low users to the cost of supplying a service, especially where the main cost is for a jointly used infrastructure. There have been huge investments in increasing capacity for mobile and broadband use, and these particularly advantage high end users.

However, with the infrastructure in place, tariffs tend to be structured in packages with high fixed and low variable costs, helping to pay for that infrastructure and reflecting the fact that there is no short-term marginal cost for additional usage.

This disadvantages those on limited means who might want a basic service at the lowest possible price. It creates a potential case for intervention to maintain an affordable basic service. Similar considerations could be applied to water supply: people who use dishwashers and sprinklers contribute to the need to expand capacity, but once the capacity exists, a flat-rate tariff could be seen as the most 'cost reflective'. This is an argument for the present policy of encouraging water metering.

The case for intervention

'... "cost reflectivity" is hard to measure accurately. From the commercial point of view, prices are more likely to be structured in ways designed to attract particular customers than the disaggregated cost of supplying each of them.'

This chapter has discussed how low income households may pay more for services either because:

- they are disproportionately affected by general market failure
- markets do not supply their particular needs on a fairly priced basis
- they are more expensive to supply.

To some extent, each of these factors should be considered in its own right, with different forms of intervention, regulatory or otherwise, addressing the particular cause of the problem. However, we have also seen that there is considerable interaction between the various causes of the poverty premium, and they are not always easy to distinguish. There are different ways of measuring the cost of supplying any one household, so 'cost reflectivity' is hard to measure accurately. From the commercial point of view, prices are more likely to be structured in ways designed to attract particular customers than the disaggregated cost of supplying each of them.

However, where this results in certain consumers in vulnerable situations having to pay more than others for essential goods and services, this can be seen as a failure of the market to provide fair outcomes for consumers. The following chapter looks at the different ways in which regulation and other forms of intervention can support more equitable outcomes.

5. Regulatory interventions – a framework and key issues

Both the privatised utilities and household credit are subjected to regulatory regimes, whose scope and focus have evolved over recent years and continue to develop. The principal function of regulation is to ensure that markets work properly, and in particular that trading takes place fairly and transparently with appropriate competition, or with compensatory protection for consumers where competition is limited. Such protection applies to all consumers, regardless of income. However, both government and regulators have also recognised the additional vulnerability of particular groups of consumers. In recent years, they have noted examples of detrimental outcomes for low income consumers, from practices such as additional charges for some energy tariffs and very high interest rates for some forms of credit, over and above what would be justified by costs to suppliers.

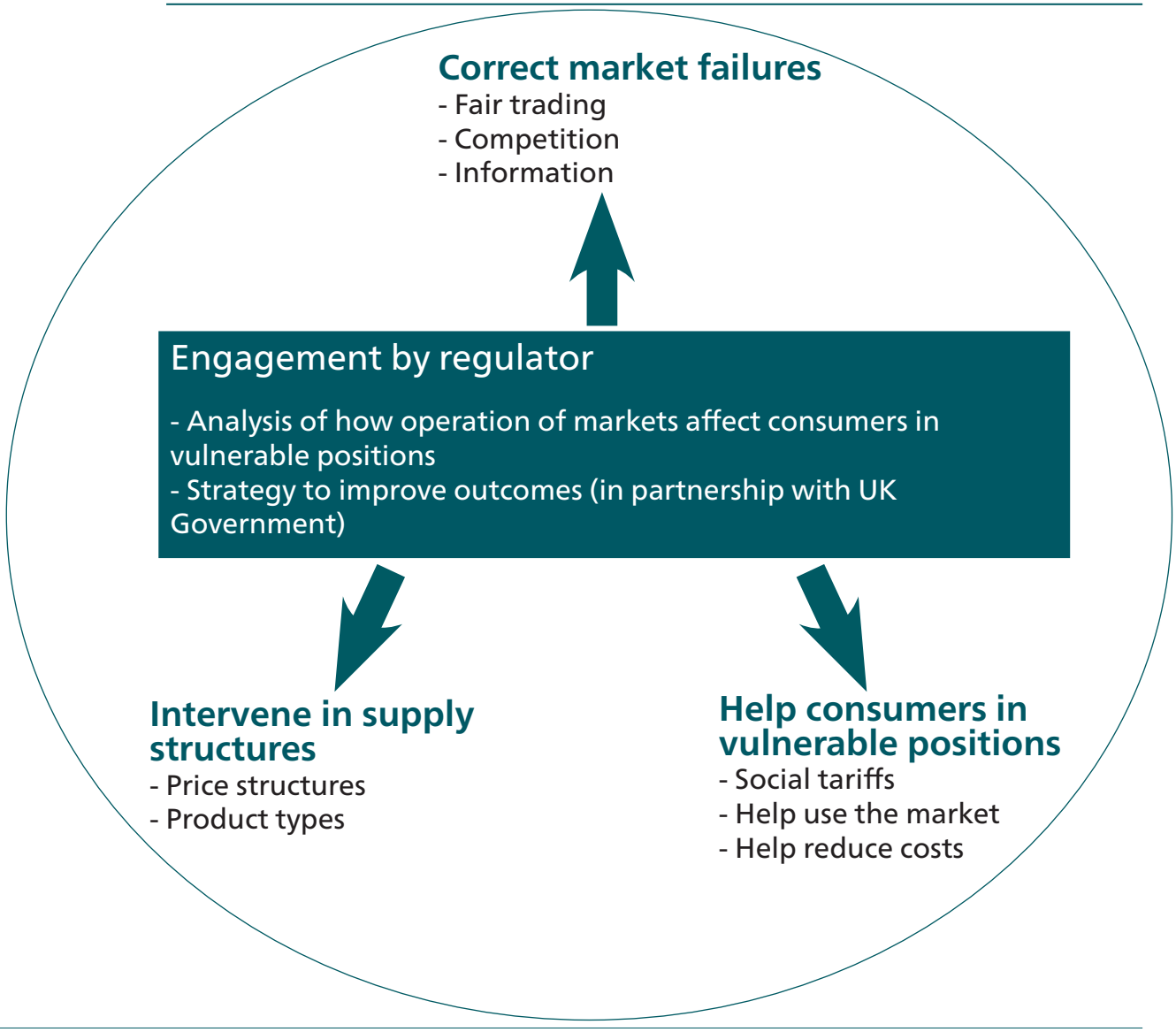
'This awareness of a weak position in the market causing some households to be in vulnerable positions and the public debates that grow up around such awareness has contributed to some fundamental rethinking of aspects of public intervention.'

This awareness of a weak position in the market causing some households to be in vulnerable positions and the public debates that grow up around such awareness has contributed to some fundamental rethinking of aspects of public intervention. In energy markets, Ofgem and the UK Government are working to achieve more equitable outcomes, partly through regulatory measures that increase controls over pricing structures (Ofgem 2012b) and partly through help targeted at consumers in vulnerable situations (Ofgem 2012a). In financial markets, the establishment in 2013 of a new Financial Conduct Authority (FCA 2012) marks a new approach to regulation. There is now a much closer supervision of conduct and products, and a commitment to step in earlier to prevent harm being done rather than acting retrospectively in response to complaints or misconduct. The 2012 Financial Services Act also allows the FCA to cap interest rates on payday loans.

These new departures reflect recognition of difficulties with the market affecting consumers generally, not just those on low incomes. However, they also mark new commitment by the UK Government to ensure that the provision of essential services by markets is not structured in a way that produces inequitable outcomes. Tackling the disadvantage of those in vulnerable situations, including those on low incomes, is bound to form part of this picture. The Department for Business, Innovation and Skills (BIS) has committed to addressing the agenda raised by Consumer Focus in its plan for tackling consumer vulnerability, including through guidance to a new Consumer Bill of Rights and driving the adoption of BS18477 which encourages companies to identify and respond to consumer vulnerability (BIS 2012).

Figure 7 classifies a range of regulatory or governmental interventions that could be deployed to address the poverty premium. Those at the top of the diagram, the enforcement of fair trading and competition, are part of the everyday task of a regulator. Those on the bottom left, regulation of price structures and product structures, are approached more cautiously by regulators (and government), because they fear stifling market innovation through over-regulation. Those on the bottom right, remedial measures aiming to assist low income households to overcome market disadvantage or to compensate them for it through forms of subsidy, tend to be the responsibility of government rather than regulators. However, regulators may help in their implementation, as well as providing valuable information about whether they are needed. And suppliers may distribute the remedial measures and have responsibility for deciding recipients (for example the Warm Home Discount).

Figure 7 Three types of intervention



A key difficulty with efforts to intervene in these ways is that there has not, in general, been a mechanism for joining them up or analysing their combined impact. At its centre, Figure 7 suggests that such joined-up thinking is needed in order to address the poverty premium effectively. In general, outcomes in the sectors under consideration have been left to the market, subject to relatively light touch regulation designed to curb unfair trading or imperfect competition.

'The eventual result was a much more widespread set of pricing regulations, designed both to limit the permitted complexity of tariff structures'

With a background of increasing costs, public and political pressure Ofgem's Energy Probe and Retail Market Review marked a departure from this pattern, introducing a closer interest by the regulator in market outcomes. The initial result of this closer investigation was to require suppliers to limit differences in tariffs for different payment types to reflect no more than the additional cost that they incurred (Ofgem 2008). The eventual result was a much more widespread set of pricing regulations, designed both to limit the permitted complexity of tariff structures and to ensure that individual customers pay no more than they need to (Ofgem 2012b). An important part of this story has been that the regulator responded to the significant disquiet about market behaviour with a commitment to investigate market outcomes and supplier behaviours more closely. Such a commitment contrasts starkly with the present situation in the communications industry, where there has been significantly less controversy, as discussed further below.

It is beyond the scope of this report to give a full account of regulatory policies and potential in each sector. However, the remainder of this chapter suggests three particular ways in which regulators might include the poverty premium in their future work by:

- taking account of the weak position of low income consumers in their regulatory activity
- considering how basic services required by all households might be made accessible at affordable prices
- actively seeking to understand in detail supplier behaviours and their outcomes for low income families, in order to inform the exercise of existing regulatory powers, to suggest where such powers might need to be extended and to suggest where government action outside the scope of the regulator may be needed.

a) Taking account of the weak position of low income groups

In addition to protecting consumers generally, regulators may have regard to the interests of those in vulnerable situations. This is articulated most directly by Ofgem, initially through a Social Action Strategy in 2005 and more recently through a Consumer Vulnerability Strategy, a new version of which was proposed in 2012 (Ofgem 2012c). Ofwat (2011) has been looking more closely than in the past at how low income households can be helped, in light of rising water bills and issues of affordability.

In contrast, Ofcom does not have a specific strategy for protecting consumers in vulnerable positions, although its annual Consumer Experience reports comment on outcomes broken down by social background.

Much of the agenda for helping consumers in vulnerable situations is designed to compensate them for market outcomes rather than changing the operation of the market itself. Some measures proposed by Ofgem and Ofwat aim to ensure that suppliers give adequate help to consumers in vulnerable positions who get into difficulties, for example by assisting them with arrears issues or finding more suitable payment arrangements. Another form of assistance is a 'social tariff'/bill reduction scheme, giving discounts to consumers who apply and meet certain criteria. This has been established in the energy sector and is being carried forward through the Warm Home Discount. In water, social tariffs have been permitted in England and Wales by legislation since 2010.

While bill reduction schemes do help offset any poverty premium for those who claim them, they do not address any of its underlying causes.

How might those causes be addressed by regulators? One approach is to look for ways of helping those on low incomes to become more active and well informed as consumers. This has been central to both Ofgem's and Ofcom's strategies for promoting better outcomes for consumers in competitive markets. However, the outcomes of such a strategy will always be limited by the extent to which households are willing and able to become more active as consumers. Consumer Focus (2012) suggests that the limited extent of switching of supplier that occurs does not simply result from a lack of information:

'Our focus groups found little evidence that consumers in the most vulnerable positions did not know about switching or hadn't switched out of inertia. It seemed to be more a lack of belief in the benefits rather than because they felt unable to.'

Any strategy to improve outcomes through better information thus needs to monitor the degree to which various groups actually respond to this, and where this response is limited, consider other mechanisms.

The latest Ofgem (2012c) proposals include a suggestion that it should look into the scope for 'collective switching', under which a single intermediary would look after a number of consumers' accounts, seeking the best deal from the available tariffs. Ofgem has warned that key issues about the behaviour of intermediaries and the transparency of the process would need to be resolved for such arrangements to work well. However, if they became commonplace, they could potentially change the nature of the market.

Rather than each consumer having to weigh up deals based on their individual situation and preferences, households could buy into a system where the decision was made for them based on their best interests. In order for this to work well and for competition based on product differentiation to be retained, there would need to be some means of articulating client preferences that was not identical across schemes. For example, a low income low usage consumer who valued stability of price over the medium term might buy into a scheme that behaved differently from an individual or collective purchaser using different criteria.

Another consequence of a regulator's awareness of the poverty premium and its causes can be to put particular emphasis on regulating the market in areas where low income consumers are most active, and where additional protection against adverse outcomes might be needed. In the energy sector, this has included the regulations referred to above ensuring that PPM customers are not overcharged relative to the extra cost of this payment method, and more recently the introduction of an obligation to allow prepayment customers to switch suppliers, even if they are in debt (up to £500).

'In the communications sector, the power to regulate prices is more constrained. The price of any service that is sold as part of a core package cannot be challenged as long as it is not misrepresented at the time a contract is entered into.'

In the communications sector, the power to regulate prices is more constrained. The price of any service that is sold as part of a core package cannot be challenged as long as it is not misrepresented at the time a contract is entered into. However, two areas outside this exemption have been the subject of enforcement action with relevance for some lower-income households. One is regulation of mobile phone companies' termination charges, which had been artificially inflating the cost of calling mobiles, to the particular detriment of older people without mobiles making calls to other people's mobile phones.

In 2011, Ofcom set a schedule for bringing these charges down to a fraction of their original rate (Ofcom 2011). The other is high charges for non-geographical calls, which also have adverse effects on some in vulnerable situations, particularly those making high use of public and voluntary and community sector services using such numbers. Ofcom is in the process of bringing in new measures to make charging for such numbers more transparent, and in particular to limit the amount that the telephone company can charge, and distinguishing the portion that pays the company providing the service.

In its Annual Review, Ofcom (2013a) highlights the issue of "protection for vulnerable users of legacy services where falling volumes may result in prices rising to unaffordable levels". In addressing this, it may need to consider not just how to protect these users from high prices in those services themselves, but whether new products meet the basic needs that the legacy products were serving.

An area where the vulnerable position of consumers on low incomes has created a particularly strong case for a change in regulatory approach has been in the regulation of consumer credit. A 2012 report by the NAO gives a damning indictment of the inadequacy of the regulatory regime.

While commending the OFT for providing value for money within the limited resources and powers available, it identifies financial detriment to consumers of at least £450 million a year arising from the inadequacies of this regime.

The NAO points out that: consumers of high cost credit 'tend to have lower than average financial understanding, lower than average income' and are therefore vulnerable to 'unscrupulous' practices by lenders. It concludes that a far tighter regulatory regime will be required under the FCA. In particular:

'The new regulator should deal with risks to consumers before they occur, where possible. In order for the regulator to be more proactive it should collect more information from firms on a regular basis. This would allow it to have a better understanding of market supply and to monitor the changing risks to consumers. The design of the new regulatory regime should also consider granting the regulator power to intervene at the product level, if necessary, to be more effective in minimising consumer harm by addressing risks associated with market structure.' (NAO 2012, summary, p9)

'...a free market that is as transparent as possible to the consumer is not always an adequate form of protection'.

This type of approach is compatible with the direction of travel envisaged for the FCA, which has also been given the power to impose an interest rate cap. A report for BIS by Bristol University in 2013 (Personal Finance Research Centre, 2013) suggested that while such a cap could bring benefits to low-income consumers, it might not always lead to a reduction in the overall cost of credit, and could potentially restrict supply.

Whether or not the FCA uses this specific power, the ability to intervene in supervising products involves a crucial change in the approach to protecting consumers in vulnerable situations. It makes the regulator much more of an agent on behalf of these consumers to ensure that the products being put on the market will not harm them, rather than just ensuring that consumers have information about the market and enabling them to complain if they have been mis-sold products or otherwise mistreated.

While particularities of the credit market limit the direct lessons that can be read across to the regulation of other markets, the principle of protecting consumers in vulnerable situations through product supervision (if necessary) is an important one. It acknowledges that a free market that is as transparent as possible to the consumer is not always an adequate form of protection.

b) Considering how basic services might be made accessible at affordable prices

'In private markets, the structure of products on offer is continuously being altered according to the market strategies of suppliers.'

The services considered in this report are essential for households in the UK, some of whom live on very low incomes. In private markets, the structure of products on offer is continuously being altered according to the market strategies of suppliers, with no automatic guarantee that some minimum level of service will be accessible to households at a stable, affordable price.

It is unrealistic, especially in the energy sector where global commodity prices are rising over the long term, for suppliers, regulators or governments to make any absolute guarantees of a product with a stable, low price. However, an alternative is to ensure that a basic, no-frills service is accessible on the cheapest terms possible, with characteristics that are stable over time. This has been a long-standing part of the agenda of those arguing for affordable services: Klein (2003) called for the Government to consult on how to make 'affordable access to a defined level of universal service in the electricity and gas sectors, and for water and sewerage services, a prime objective of the regulators.'

'...an alternative is to ensure that a basic, no-frills service is accessible on the cheapest terms possible, with characteristics that are stable over time.'

In the communications sector, the Universal Service Obligation (USO) provided such access to landline telephones following privatisation, and was initially a highly valued service to over two million users. Under one of the tariffs under this scheme, any low-use customer was able to keep their bills down, with a reduction in standing charge in inverse proportion to usage. (This was effectively paid for as a cross subsidy from other customers.)

Most users were found to be on low incomes. Following an Ofcom review of the scheme in 2005, access to the scheme was linked directly to benefits, and reductions for low use diminished (Ofcom 2005).

Use of the USO has reduced over the years, as a basic landline connection has become less relevant in meeting households' essential telecommunications needs. A service that fulfilled an equivalent function today would need to include mobile and broadband access (the USO only includes internet access via a dial-up modem). Ofcom ruled out the inclusion of broadband in its review, partly because its usage was not yet widely enough established (a situation that has changed since that time), and partly because the European Directive that permits a USO does not include broadband. Yet the question remains: whether a principle of making universal access affordable that was relevant and led to a well used service in the 1990s is relevant, today, in relation to an updated set of essential telecoms amenities. Arguably, the access that the internet gives to social participation makes it even more essential than the telephone was 20 years ago. Insofar as Ofcom's regulatory powers to extend this principle are constrained by national and European legislation, this raises broader issues of whether such legislation should be brought more up to date.

'For any low-usage tariff at low cost, one question is whether there would effectively be a cross-subsidy to its users, and if so whether this subsidy could be justified'

The maintenance of a universal postal service, on the other hand, is a case where affordability continues to be a consideration, and Ofcom (2013b) has recently reviewed whether the service meets its users' needs. In doing so, it has decided not to change the scope of the current universal service, which remains highly valued by many users despite the shift towards electronic forms of communication.

In the energy sector, Ofgem raised the idea of a 'backstop tariff' in initial proposals following its Retail Market Review (Ofgem 2011b), which were not then followed through into its final proposals. The form of tariff that it originally suggested taking forward would have been targeted particularly at consumers in vulnerable situations, unable or unwilling to navigate the market, and might be priced relative to a basket of other available tariffs.

One difficulty with such a tariff is that if its main purpose were to provide a simplified version of the other tariffs that it tracked, it is unclear how it would be particularly suited to low income consumers, and may not achieve anything different from a collective purchasing arrangement. Alternatively, a backstop tariff designed more like the original telephone USO might guarantee relatively low prices for low-use consumers, and thus be better targeted at a particular market without requiring a gateway reliant on a means test or benefits status.

For any low-usage tariff at low cost, one question is whether there would effectively be a cross-subsidy to its users, and if so whether this subsidy could be justified (especially if there were no means test). One point to take account of here is the one made in the previous chapter about the difficulty of accurately identifying the cost reflectivity of a charge to any one user, especially following a large investment in say telecommunications infrastructure.

At a commercial level, at a point in time where there is available capacity, the tendency may be to charge similar prices to all consumers for use of this infrastructure, regardless of usage levels. But from a social point of view, there is an argument for charging less to low-use customers requiring access to a service which, had others not had higher usage levels, would have been cheaper to provide.

A related question concerning cross-subsidies in relation to high and low users is how money is raised from consumers for social purposes. In the energy sector, a significant issue in the years ahead will be how measures to reduce carbon emissions by helping homes to become more energy efficient are financed. The new Energy Company Obligation (ECO) requires energy companies to facilitate the installation of energy efficiency measures in homes before a set deadline. It will provide particular support to those on low incomes.

However, by financing such measures through energy bills, it will have the effect of raising the cost of energy for those not accessing its advantages. In earlier (Carbon Energy Reduction Targets) schemes, companies levied a charge per household – effectively increasing the price per unit consumed most for low-end users and hence increasing the poverty premium. In the present scheme (ECO), the aim is for the levy has become more proportionate to the consumer's overall energy bill. However, it would be possible to go further in order to limit the effect on low-income low-use households, either by imposing the levy only on usage above a certain level, or by financing these measures through general taxation.

An additional issue is that the vast bulk of the Government's energy policies are paid for through levies on electricity bills, for example ECO, the Renewables Obligation, contracts for difference, Feed In Tariffs. There is only one levy on gas bills, namely ECO. This means that consumers with electric heating pay a disproportionate share of the cost of policies, yet receive less than their 'fair share' of the benefits of policies and tend to be on lower incomes.

Recent research published by Consumer Futures, *The hardest hit – going beyond the mean*, (Consumer Futures, 2013) found that in 2020, electrically-heated households:

- represent 11 per cent of consumers by heating fuel type
- pay 19 per cent of the total cost of the UK Government's energy policies
- receive 7 per cent of the benefit s of energy policies
- those not receiving benefits will see their bills go up by an average of £282 per year, as a result of energy policies
- this compares with an average decrease of £31 per year for all consumers, as a result of energy policies.

The research found that consumers with electric heating in purpose built flats and consumers with electric heating (any type of property) with at least one pensioner householder were particularly unlikely to receive any of the benefits of the Government's energy policies. It suggests providing an extra consumer credit to these households, as well as targeting them with energy efficiency measures.

As a parallel to a basic, regulated tariff available to utilities users, there is also scope for ensuring that consumer credit is available to people on low incomes on controlled terms. One previous method of allowing low income households to buy goods on credit at affordable terms, the Social Fund, has become a more restricted option since the reduction of its funding and its devolution to local authorities.

'...regulators need to know whether present market outcomes are equitable.'

Another mechanism, credit union borrowing, has never been available on a large scale in Great Britain, nor provided serious competition to commercial lenders which might help curb interest rates in loans to low income households. However, in other countries such as Germany, as well as in Northern Ireland and the Republic of Ireland, credit unions, or their equivalent, have been a much more important part of the domestic credit market. The UK Government is consulting on raising the interest rate cap for credit union lending, from 2 to 3 per cent per month (HM Treasury 2012), which by making such lending more viable might help increase its volume to a level that makes it far more widely accessible.

Regulator-led assessment of markets and their outcomes for low income groups

The amount that regulators know about the markets that they are regulating in part depends on the scope of their powers and thus the areas of supplier behaviour and outcomes that they choose to investigate. However, in order for the UK Government and Parliament to consider whether to amend these powers, regulators need to know whether present market outcomes are equitable. In the case of whether households on low incomes are paying higher than necessary prices for packages of essential services, this requires quite detailed investigation of both supplier and consumer behaviour and of the actual cost of supplying various services, in the context of an ever-changing landscape.

In recent years, there has been a considerable contrast in this respect between the experience of the energy and communications sectors, in part because of the external pressures resulting from rising prices and fuel poverty in energy contrasting with decreasing costs in communications. Starting with its supply probe in 2008 and continuing with its Retail Market Review, Ofgem has looked in considerable detail at how energy companies behave, including whether the tariffs being paid by lower income consumers genuinely reflect additional costs. This has contributed to initiatives both by the UK Government and the regulator to exert greater control over tariff setting, starting with the requirement of greater cost reflectivity, and leading in 2012 to a much more comprehensive set of constraints about the ways in which tariffs are structured (Ofgem 2012b). The more that the regulator has uncovered knowledge about detriment to consumers (and particularly those in vulnerable situations), the more this has created the case for greater intervention, which in turn prompts investigations about whether the desired results are being achieved.

'...The more that the regulator has uncovered knowledge about detriment to consumers (and particularly those in vulnerable situations), the more this has created the case for greater intervention'

In contrast, Ofcom's annual review of consumer experiences in communications markets looks broadly at certain outcomes for consumers, including those on low income and in vulnerable situations, but does not investigate issues such as price setting practices, cost reflectivity or whether lower-use consumers are paying a fair price. Its evidence focuses on general price trends, consumer satisfaction levels and coverage, all of which have been improving until recently, although price levels especially for low-end users have started to rise. On the basis of this evidence, the regulator has not felt the need to argue for any extension of its powers of intervention in relation to prices, even though these are constrained, for example, by the fact that "core" parts of phone contracts are not subject to a fairness test provided that they have been transparently agreed.

Because the communications sector has not seen the cost increases that have occurred in the energy sector (although the growing composition of an essential household package of communications, to include mobile phone and internet as well as landline, means that the overall cost of such a package has grown for many households), there has not been the same pressure to investigate whether some groups are paying too much for such services. But it is worth asking what would happen if prices paid by low-end users rose substantially relative to high-end users, continuing a trend observed recently in the mobile phone market (Ofcom 2012) – especially if this effect was influenced by the greater price-sensitivity of high-end users rather than to any objectively justifiable cost differences.

With rapidly changing technologies, it would be difficult for Ofcom to confirm if these trends were cost reflective, without closer investigation of the market. Ofcom does not at present have the power to regulate the level or structure of basic tariffs, but without such investigation, it would not have the basis to argue for any extension of its powers.

Knowledge limitations have also been significant until now in the regulation of consumer credit markets. According to the NAO (2012, summary page 9):

'The OFT does not collect information on the level of lending provided by each firm and therefore does not have a quantified understanding of the supply in the market. This, combined with the lack of information about consumer harm, means the OFT cannot provide assurance that its enforcement actions are targeted towards those areas which will have the highest impact, either in terms of number of consumers or level of harm involved. The model used by the OFT to determine the risk level of a credit activity has not been regularly updated since its development in 2007, despite a rapidly changing market over this period.'

As noted above, the NAO report goes on to recommend that closer supervision of the activities of lenders under the new regulatory regime should be combined with the collection of much more detailed information on their activities.

6. Conclusions

'Regulation to ensure that low income households are fairly treated in these markets can influence their living standards significantly.'

This report has demonstrated how households on low incomes have suffered systematic detriment in paying more for certain essential services. This produces a challenging agenda for regulators. The vulnerable position of these households as consumers in utilities and credit markets is of particular importance because of the impact on low income households' ability to maintain an acceptable standard of living. Utilities spending combined with the purchase of larger household goods on credit can comprise between a fifth and a third of an essential household budget, while lack of access to financial products and to the internet can have significant implications for the amount paid for other goods and services. Regulation to ensure that low income households are fairly treated in these markets can influence their living standards significantly.

The analysis has distinguished between different kinds of 'poverty premium' according to whether they result from lower income groups being more expensive to serve, or whether from exploitation of their weak position in the market. However, an important overall conclusion is that it is not always easy to draw a clear-cut distinction between the two. The precise cost of serving an individual consumer is not easy to disentangle, and commercial strategies do not base pricing structures merely on cost criteria. Where companies treat low income consumers as 'captive markets', they will always tend to tilt prices in favour of groups more active in switching supplier.

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Regulators and governments are able to employ a range of strategies to improve outcomes for low income consumers. In some cases they compensate for poor market outcomes, for example through social tariffs/bill reduction schemes; in others, interventions in markets themselves seek to achieve better outcomes. A first step tends to be to encourage people to be more effective consumers by providing them with information

But a realistic approach recognises the limits to how far households will become 'active consumers', and provides help that does not rely on everyone actively and accurately seeking better deals. One option is collective switching schemes. Another is for regulators to exercise direct influence over pricing and supply structures. A longstanding challenge is to look for ways of ensuring that basic products are available at reasonable prices for people requiring affordable access to these services.

It is essential to acknowledge that there is no 'one size fits all' approach to regulatory approaches to the poverty premium appropriate for all sectors.

'There is no "one size fits all" approach to regulatory approaches to the poverty premium appropriate for all sectors. In particular regulators in each sector need to find the right balance between intervening to control supply and pricing structures and allowing free market competition to produce the innovation that contributes to delivering better services at attractive prices.'

In particular regulators in each sector need to find the right balance between intervening to control supply and pricing structures and allowing free market competition to produce the innovation that contributes to delivering better services at attractive prices.

However, this report has argued that a common feature should be that regulators in all sectors should at least take account of the potential for low income households to do worse in free markets, be willing to investigate in detail the extent of such disadvantage, and put the case where needed for new forms of regulation that could help address it. In some cases, the UK Government needs to become involved in this conversation, either because regulators' present powers are constrained, or because some remedies are more appropriately the responsibility of the UK Government rather than the regulator. Where markets are operating fairly, but people on low incomes are ill equipped to benefit from them, compensatory measures are more a matter of social policy than of regulation.

Specifically, this points to the following recommendations. Regulators:

- should continue to work to help all consumers have good information about markets and to be active in switching between providers
- should not assume that such help in being 'active consumers' will provide sufficient to protection for disadvantaged groups. They should continuously monitor whether people on low incomes are less active and, if so, consider what further protection is needed in order to ensure that they do not suffer a 'poverty premium'
- should look closely at whether products used disproportionately by households on low incomes are being fairly priced relative to other products, and in particularly at whether price differences can be justified on cost grounds or whether low income consumers are being exploited as a 'captive market'
- of essential services should be given the remit to investigate structure and level of pricing where they have justified cause for concern on the above grounds
- and the UK Government should look together at the case for intervention in the structure of the supply of essential services to assure basic products at affordable prices.

The extent and character of any poverty premium will differ by sector and will change as new technologies and products enter the market. What is important is for regulators to be able to monitor closely outcomes for households on low incomes. And present differences in regulatory powers should not stop them from finding these out, in order to inform the future shape of the regulatory landscape.

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