

Consumer Focus Board

Paper 12.1

Title: Consumers and cross-subsidisation
Purpose: Information and discussion
Date of meeting: 13 October 2009
Responsible officer: Robert Hammond
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Attachments: None

1 Overview

- 1.1 Cross subsidisation is an important strategy issue related to a number of markets that we work in. This paper sets out some basic principles and understanding that we have of the nature of cross-subsidies, with its primary focus on the energy market. It draws on the position of cross-subsidies in other regulated industries and is meant as a starting point for more in-depth Board debate as to which cross-subsidies are worthy of our support and under what circumstances.
- 1.2 This paper is intended to address the broad question of whether Consumer Focus should support cross-subsidisation in the markets discussed herein, and under what circumstances.

2 Action

- 2.1 The Board is asked to discuss the principles of the Consumer Focus approach to cross subsidy, to provide a steer to further internal policy debate.

3 The key issues

- 3.1 As a consumer advocacy body we are most interested in cross-subsidies in so far as they mitigate market failure; that is to say, if the subsidy was not in place, a group of consumers would pay prices at a level we consider unfair. This unfairness is of course open to interpretation, both internally and externally. Arguably cross-subsidisation could be stretched to refer to things like Governmental environmental levies; however this paper considers only those which fall under the traditional definition.
- 3.2 Cross-subsidisation is therefore present wherever individual consumers do not cover the "Incremental Cost" i.e. the cost of provision that arises solely and only due to their consumption. Those subsidising face prices higher than their own "Stand Alone Cost".
- 3.3 There are six main cross-subsidies in utilities:

- a) Between payment channels for domestic consumers (standard cash/cheque subsidising online direct debit, for example);
 - b) Between regions for energy supply (such as subsidising consumers in the most remote areas of Scotland);
 - c) Between consumers in the same, say, water region who face different costs to serve but uniform tariffs for water and sewerage
 - d) Between the supply of gas and electricity respectively (electricity subsidising gas, hence unfairness if a consumer is off the gas grid);
 - e) Between social and non-social tariffs (the cost of the former being smeared over the far larger latter group);
 - f) Between supply and generation in vertically integrated energy companies (and thus the potential for anti-competitive behaviour given the currently opaque nature of such relationships).
- 3.4 Historically we and other consumer bodies have prioritised actively “progressive” and thus explicit cross-subsidies such as social tariffs over dealing with “bad” (implicit) cross-subsidies, such as that between the supply of gas and electricity. Largely this seems to have been a result of political trends rather than economic analysis – it looks more impressive to be actively “doing something” new rather than mitigating less clear existing issues. Ofgem’s Probe has thrown the spotlight onto previously less well-publicised (except by energywatch) implicit cross-subsidies like that between gas and electricity supply.
- 3.5 However, it is important to note that cross-subsidies can be of two distinct types; those that are direct or targeted (such as social tariffs) and those that emerge from the market working inefficiently. In theory, in a truly competitive environment price structures from the latter would not usually survive competition as another firm will offer lower prices to encourage customers to switch. But this assumes that only a few suppliers are cross-subsiding; if all or most are doing it consumers are trapped. There will also have to be no significant barriers to new entry (i.e. low levels of contestability) for effective choice to be exercised.
- 3.6 Also of importance is consumers’ propensity to switch – if consumers do not want to switch (even for lower prices) then energy companies do not have an incentive to keep their prices as low as possible. They could then cross-subsidise by reducing prices for customer groups that are most sensitive to price rises so they do not switch to a competitor i.e. they could price discriminate. This also occurs if consumers suffer from informational market failure (i.e. high search costs) and thus are unaware of lower prices from another supplier, or when (as between the Big 6 energy suppliers) price differences are so small as to make consumers largely indifferent between them.
- 3.7 Where there are common fixed costs of production to be allocated among customers, prices will be varied by companies depending on how sensitive consumers are to price changes e.g. more costs allocated to customers that are unlikely to switch and fewer costs allocated to those that are more likely to switch. In this instance, it would be difficult to establish whether there is any cross-subsidy as it is not possible to say exactly what part of the common cost is attributable to each customer group.

4 There are several starting positions regarding the use and implementation of cross-subsidies, but they are not uncontroversial:

- Cross-subsidies should not be used to restrict, distort or prevent competition - except when the social outcome is better than if left to the “competitive” market;
- Cross-subsidies should be open and transparent e.g. regulated companies should be able to justify cross-subsidies and their level. However, this is likely to change over time and be affected by politics rather than economics;
- Cross-subsidies should be justifiable on social grounds i.e. where there is a cross-subsidy, it should benefit the most vulnerable consumers. This is only true if there is no cheaper or more efficient way of achieving the end price/outcome;
- Cross-subsidies should not result in undue discrimination towards a group of consumers. The main contention here is who decides the definitions of “due” and “undue”;
- Cross-subsidies should not be used to create unfair price differentials – by payment type, geography, dual fuel vs. electricity-only etc. Again the question here is that of “fairness” and its definition;
- Cross-subsidies should not be used to fund inefficiencies and should not replace the need for a company to remove inefficiencies from its business. However some would argue popular cross-subsidies like social tariffs do precisely this.

5 Social tariffs as a cross-subsidy: the road to hell?

- 5.1 Various commentators, such as Dieter Helm,¹ have asserted that social tariffs, despite their broad political support, are not the optimal way of dealing with fuel poverty. Social tariffs² are funded via increased bills for other customers. In the present economic climate, more energy consumers are likely to fall into fuel poverty, thus increasing the cost of helping those consumers. Therefore the likely scenario is that other customers groups will see their bills continue to increase to meet the costs of more people in fuel poverty – and the increase in bills could push more customers into fuel poverty. Thus cross-subsidies create a vicious cycle, particularly in an era of more expensive energy.
- 5.2 Ofgem have previously criticised social tariffs – in 2001 they stated: “We regard a reliance on cross-subsidies as an ineffective means of helping the fuel poor. These are difficult to target effectively. Cross-subsidies favour incumbents, making customers less attractive to competitors, thereby reducing pressures to innovate.” A more basic economic argument against social tariffs is that it is more efficient to increase consumers’ incomes directly than to reduce the nominal price of a good or service (both increase consumers’ real incomes). Thus government should use tax cuts and/or benefit increases to make energy more affordable rather than cross-subsidisation and social tariffs. Indeed this argument has been articulated by the Big 6 energy suppliers.
- 5.3 However social obligations on supply businesses require the latter to exercise their market power. It is inconsistent to demand that companies act competitively and at the same time force them to exercise their market power to deliver the “public good”

¹ Fuel poverty paper [link](#)

² Ofgem requires social tariffs to be equal to the cheapest deal offered by energy companies ([link](#))

(whose very definition is contentious) and therefore damage competition. That is why it is far better to levy social obligations on the monopoly businesses which already (by definition) have market power and are essentially a tax system.

- 5.4 Regardless of social tariffs, it is generally difficult to target cross-subsidies in a bid to assist those on low incomes. For example, if PPM costs are lower because of cross subsidies from other customers then all PPM customers benefit regardless of whether they are vulnerable or fuel poor (Ofgem research shows that only 22% of consumers in social groups DE pay through a PPM, 26% of fuel poor pay for at least one of their fuels by PPM, 16% of fuel poor pay for both by PPM. So PPM customers are not a good proxy for vulnerable groups or the fuel poor). Similarly, consumers on other payment methods could be vulnerable or fuel poor but experience higher costs for their fuel because the revenue received from their payment method is used to cross-subsidise other payment channels.

6 Networks and the benefits of cross-subsidisation

- 6.1 While most stakeholders agree with the arguments for income assistance or a social tariff, the case for subsidising consumers because of where they live is a more complicated issue. Some would argue that people can choose to move to another area (particularly if energy is just one of many comparatively expensive services due to geography, alongside access to culture, transport etc) and so cross-subsidies here are less appropriate. Whilst this position is somewhat extreme, it seems reasonable to argue that cross-subsidies because of geography should be a low priority compared to those concerning low income.
- 6.2 This is not the government or mainstream stakeholders' view, hence the introduction in 2005 of the "assistance for areas with high distribution costs". This scheme replaced a "hydro benefit" scheme which had been devised over 50 years previous for social policy reasons to subsidise high distribution costs in northern Scotland³.
- 6.3 The scheme cross-subsidises the costs of distributing electricity in a particular area of Great Britain if these are significantly greater than distribution costs elsewhere, thus shielding consumers in areas with high electricity distribution costs from the relatively high electricity costs that would otherwise arise. Average distribution costs in the North of Scotland are easily the highest of any region in Great Britain. In 2002/3 the average distribution costs there without the subsidy would have been around 100% higher than the overall GB average, mainly because of the large, sparsely populated terrain that must be wired to carry electricity to local consumers.
- 6.4 In practice, the scheme means that a payment is made to an electricity distributor, when that distributor faces costs that are significantly higher than the costs of

³ Hydro benefit was applied through a reduction in the allowed revenue of the distribution company's price control which set the maximum sum of money that the company is permitted to recover from its customers for use of the electricity distribution network. The distribution business received an annual payment from the generation business to cover the high costs of distribution.

distributors in other areas of the GB. The payment must be passed on from the distributor to suppliers in that area, and is funded by charges on suppliers across Britain (charges which are in turn put on consumers via bills). In essence, this scheme means that almost £40m is transferred from all electricity consumers in GB to those located in northern Scotland (which worked out at about a 0.2% increase in average prices for a domestic end user in 2002 – less than £1 per year per customer - if all suppliers passed on the cost of this to all its customers). The scheme is subject to review at 3 yearly intervals.

- 6.5 There are still significant differences in network costs across Great Britain, however, due largely to higher distribution costs (even with the scheme described above) in the non-English supply regions:

Supply region	Annual network charges total (£) in April 2009 (medium user single rate meter)
Swalec	101.80
ScottishHydro	101.01
SWEB	96.76
ScottishPower	94.88
Southern	86.78
ScottishPower Manweb	86.44
Northern	80.98
Yorkshire	77.22
London	75.76
Norweb	75.15
Midlands	75.08
Eastern	72.99
East Midlands	71.81
Seaboard	70.30
GB average	83.35
England average	78.28
Wales average	94.12
Scotland average	97.95

- 6.6 The market-created cross-subsidy (if it exists) is in monopoly network businesses subsidising the otherwise liberalised generation and supply businesses. Ofgem is currently engaged in various Probe-spin-offs connected to this which will require more rigorous separate accounting and transparency so as to establish whether such anti-competitive behaviour is occurring. Consumer Focus is heavily involved in these initiatives as we consider it crucial for the development of a competitive fringe so as to allow rivals to discover where profit making opportunities exist throughout the supply chain. This will provide consumers with greater choice beyond the Big 6.

- 6.7 Indeed the Probe touches heavily on issues of cross-subsidisation, and on 1st September 2009 Ofgem implemented its new licence conditions on prohibiting undue discrimination. These are designed in part to ensure that charges for the supply of electricity and gas shall reflect the costs to suppliers of the different payment methods (Licence Condition 27.2A) and thus implement this aspect of the relevant European Directive (Annex A(d) of Directives 2003/54/EC and 2003/55/EC).
- 6.8 Furthermore, a second Licence Condition (Licence Condition 25A) seeks to ensure that in supplying electricity and gas, the terms on which it is supplied does not discriminate without objective justification between one group of consumers and any other such group (this includes different energy pricing for those customers in or out of the former incumbent electricity supplier areas and on or off the gas grid). It shall be for Ofgem to decide whether there is any such objective justification. The licensee will only be in breach of Licence Condition 25A if and to the extent that the nature of the discriminatory terms offered and/or their impact on any Domestic Customers is material in any respect. Guidelines have been provided which give basic principles for when price discrimination is legitimate or not⁴.
- 6.9 These Licence Conditions are supported in the main by Consumer Focus and the monitoring of their effects is the next step from our perspective.

7 Lessons from another essential commodity?

- 7.1 A prominent cross-subsidy in water supply is that from metered consumers (who pay for the quantities they use, much like energy consumers) to those non-metered; the latter paying bills based on the very loose and now outdated proxy of the rateable value of their property. It is hard to make the case that this is a cross-subsidy of any social merit; indeed, given the voluntary nature of a meter, conscientious and frugal consumers are those likely to self-select thus leading to a rump of comparatively wasteful non-metered water consumers.
- 7.2 Furthermore, given the inability of many households to obtain a meter, despite their desire and the lower bills it would result in, there is a second cross-subsidy from this group to both metered consumers and the aforementioned non-metered wasteful consumer subgroup. The key lesson from both is thus that one cannot allow one class of consumer to opt out (or opt into) a cross-subsidised regime; at best this can only be a transitional measure.
- 7.3 Despite energy's status as an essential commodity, disconnection by supplier for non-payment of bills is both legal and practised. This is not the case for water; regional supply monopolies (e.g. Thames Water in Greater London) cannot turn off the taps and as such bad debt (a feature of virtually all markets) is loaded onto other consumers' bills to the value of around 3% as a consequence. This is undoubtedly another detrimental cross-subsidy (three times larger than that for energy) thrown up

⁴<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents/1/Guidelines%20on%20Cost%20Reflectivity%20and%20Undue%20Discrimination%20in%20Supply.pdf>

by the nature of Ofwat regulation, despite the fact that Ofwat has a statutory duty to not unduly discriminate.

- 7.4 The Walker Review's interim report of June 2009 appears to support this view, with the recommendation that metering (as in energy) increasingly becomes the norm, particularly in those parts of Britain where water is more scarce. In addition there will be a move away from impotence on the part of suppliers regarding consumer non-payment. The report states that the current and large differentials (£280-£500) between regional prices are both acceptable and fair, however.

8 The examples of post and telecommunications

- 8.1 Whilst not an essential commodity, the mainstream consensus is that a free market in post would not work in consumers' best interests, hence the "universal service obligation (USO)". A nationwide postal service at a uniform price obviously cannot be provided by markets without monopoly privileges and/or legislation as the sunk costs are too great. The USO means two explicit cross-subsidies; the first is a locational one that involves urban or intercity mail keeping the price of rural mail down.
- 8.2 Secondly there exists a volume-based cross-subsidy from bulk mail (e.g. direct mail) onto the price of single-piece mail so as to ensure those on low incomes have access to the mail service at a price they can afford. Given Royal Mail's inefficiency it now longer self-finances the USO (last year Royal Mail lost £100 million on its USO business activities) and the fear of many consumer groups is that a likely part or full privatisation in response to this would mean a shift to market-based pricing by zone. This would result in consumers paying based on additional factors like the distance the mail is travelling; thus the average cost of mail for domestic consumers would undoubtedly rise.
- 8.3 The role of cross-subsidisation here would seem to be, arguably, a legacy of a pre-internet era when affordable access to mail was of crucial importance. It is likely that the justification for the USO (and thus the explicit cross-subsidies) will decline over time as those consumers not online declines. However mail is not purely about communication, and thus there is an argument to be made regarding a USO in logistics so that "fulfilment mail" (that cannot be sent electronically, such as parcels) grows steadily, as predicted.
- 8.4 In telecommunications Ofcom ensure that there is a universal service in fixed line telephony. In practice this means a cross-subsidy to consumers in remote and rural areas that the market would not otherwise serve. There is also a second, very recent USO that aims to ensure all have access to broadband. The cross-subsidy here will levy £6 on fixed lines as a way of funding non-economic internet expansion in remote areas. In contrast to the USO in mail this is likely to become more and more justifiable as broadband subscriptions continue to rise and access to the internet becomes increasingly likened to an essential commodity.
- 8.5 In addition BT controls prices for new landline installations such that consumers with costly requirements are not subsidised by more basic-service demanding and thus low cost consumers.

9 Proposal

- a) Is our priority as an organisation the promotion of explicit “progressive” cross-subsidisation or the mitigation of implicit detrimental cross-subsidisation? Do we have to choose?
- b) Given the increased efficiency of higher real incomes over lower real prices why do we so vigorously support social tariffs as they stand? Why not use distribution (the monopoly part of the energy supply chain) or the benefits system?
- c) How should we determine consumer responsibility for price differentials? Can't people just move house if they are that aggrieved by paying more for goods and services? Or does the Scottish Highlands scheme not go far enough in keeping prices fair?
- d) When can we be satisfied that Ofgem's Probe work has done enough to mitigate detrimental cross-subsidies? Can we ever be sure that companies are not behaving anti-competitively by looking at the new data provided, and will the market work to eliminate the rest?
- e) What lessons does the water industry have for energy, particularly as the former seems to be going in the direction of the latter in terms of metering? When does the essential nature of a good become trumped by the burden of significant bad debt and non-paying consumers' anti-social behaviour?
- f) At what point will the USO in post become increasingly anachronistic? Why not a USO in logistics for parcels and the like? Do consumers understand and appreciate that the direct mail that many dislike keeps their personal mailing costs down?
- g) Should the key USO in communications become that of access to the internet, even if that means accelerating the decline of conventional mail? Is being online an essential commodity deserving of a significant cross-subsidy?
- h) A future paper on the use and application of environmental subsidies might prove useful in extending the ideas in this paper.