



Making Markets Work (Phase 2): Engaging with Providers

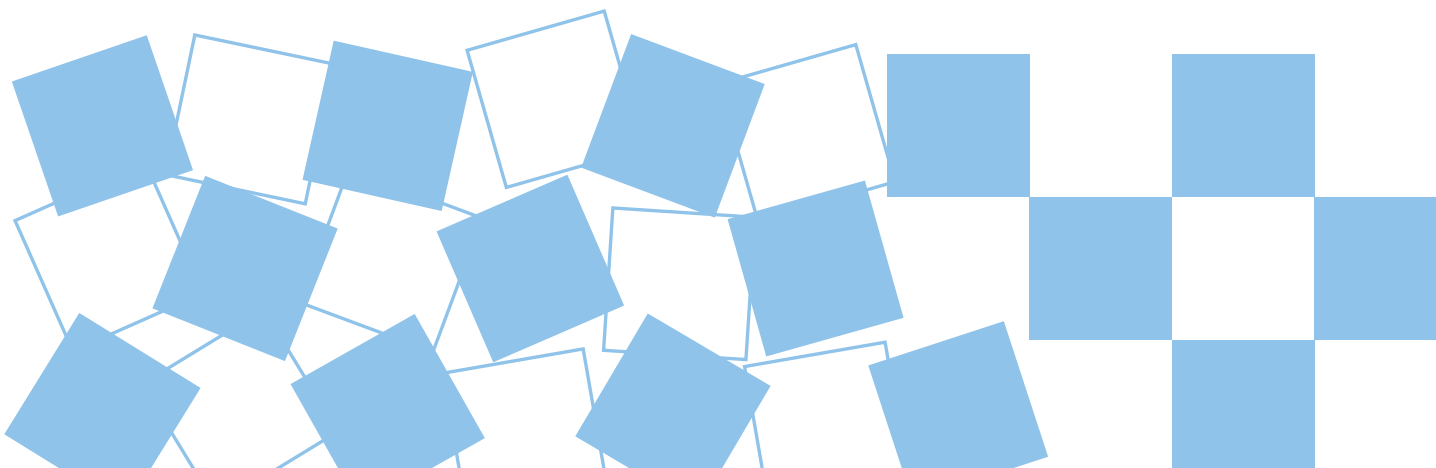
Main Report

By the **Scottish Council Foundation**
June 2008



Supported by
Scottish Centre for Regeneration
and The Scottish Consumer Council

SCC **Scottish
Consumer Council**
Making all consumers matter





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Responsibility for the content of this report, including any errors rests with the authors.

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1. Introduction and background

The Scottish Council Foundation, with support from the Scottish Centre for Regeneration, undertook a study into the market provision of essential goods and services to low-income consumers (SCF, 2007). The study identified the main causes and consequences of the current difficulties encountered by low-income consumers¹ in using essential goods and services (personal finance, household energy and retail services) and reviewed practical actions that could reduce the effects of market dysfunction.

This study builds on our earlier report which identified the need for a much deeper appreciation of private sector knowledge and assumptions about the barriers to (and opportunities for) market provision to households and communities constrained by a perceived lack of profit potential. Here we focus on household energy, telecoms and retail sectors to identify the main factors in stimulating and supporting better-functioning markets, and greater choice and value for money for low-income consumers. We believe that better functioning private sector markets can offer low-income consumers access to the goods and services they need, at a price they can afford, in ways they are able to pay and delivered to them in ways that most suit.

Rather than assuming a lack of willingness by providers to meet low-income consumer needs, we believe the underlying issues are both subtle and complex. This is why we felt it necessary to engage with a range of providers to seek their views on:

- How they identify and understand the service needs of low-income consumers and communities;
- How these are taken into account when shaping provision;
- Models of practice that have been developed around addressing low-income consumer need and stimulating demand, while generating long-term profitability;
- How provision of goods and services might be shaped in the future.

We interviewed representatives of key companies in each sector (Retail 3, Telecoms 6 Energy 2) and conducted nine interviews with consumer interest bodies and independent experts.

We also carried out a literature review covering:

- International trends in payment technology,
- New ways of assessing credit worthiness of low-income consumers,
- Alternative ways of understanding the market potential of low-income neighbourhoods, *and*
- Corporate Social Responsibility reports for key companies in each sector

¹ In the UK, households are considered to be living in poverty if they have less than 60% of the median household income (where the median is the level of income after direct taxes and benefits, adjusted for household size). In Scotland, 18% of the population live in relative poverty before housing costs (880,000 individuals), rising to 20% after housing costs (990,000 individuals). Figures included in Scottish Government (2008) *Taking Forward the Government Economic Strategy: A Discussion Paper on Tackling Poverty, Inequality and Deprivation in Scotland*.

2. The hidden costs for low-income consumers

Low-income consumers, many living in Scotland's poorest communities, represent sizeable sources of market demand. But their purchasing power is poorly organised and their need for various essential goods under-served. Many service providers appear reluctant to tailor products or payment methods to ensure low-income consumers can afford them. As a result, key drivers elsewhere in the economy notably rising consumer expectations of choice and value-for-money function only weakly for a sizeable minority of households and neighbourhoods. The distribution of resources and opportunities is unequal and in some cases could be considered discriminatory. In addition, goods and services taken for granted by the majority of consumers are more likely to be of poorer quality, more expensive, or come with conditions attached that make them less attractive (such as no option to pay in cash or to pay more frequently than monthly).

Various basic demands are made on the limited budgets of low-income households such as paying for heating and light, telecoms, food and transport, before housing costs are considered. Taken together, expenditure on these items tends to represent a higher percentage of income than for other more affluent households. A combination of low-income, no bank account, irregular earnings and poor credit scoring means that many low-income consumers avoid long-term financial commitments for fear of ending up in debt. Financial management is very important for low-income consumers and for many paying by cash is the surest way to control costs. However, paying in cash (either through need or preference) often adds more to these costs.

For those wishing to pay by cash or cheque there are a range of options available including Post Office counter services and PayPoints. Cash is the simplest method of payment for virtually any type of transaction. There is no immediate risk associated with cash transactions (other than with security), unlike other forms of payment such as cheques, electronic transfers and other IT-backed systems that can fail. For example, cash payment into a bank account is credited immediately whereas cheque payments can take up to five working days to clear. The downside is paying by cash can cost the consumer more than other methods. For example, many telecoms providers charge between £1 and £5 per transaction if customers choose not to or cannot pay by direct debit, or offer an incentive to those who do pay by direct debit. Others do not provide services to customers unless they pay by direct debit.

While household energy companies do not tend to charge a fee to non direct debit customers, they do offer discounts for those paying by direct debit, and the best tariffs for those paying on-line. Almost all providers of goods and services now prefer to collect payments by direct debit. They believe there is a greater risk of those who do not pay by direct debit being late with their payment or missing payments entirely. However, for some customers direct debit payments taken from accounts when funds are not sufficient result in additional bank charges, thus compounding financial difficulty. While it is legal for companies to charge different amounts for different methods of payment, what is less clear is the *actual* cost to suppliers of processing different payment options. *It can be argued that regular payments in cash carry little risk and marginal extra cost to providers, and that charges reflecting higher costs should apply solely to customers who are late in paying.*

There are 2.8 million UK adults in the UK (1.9 million households) without a bank account who rely on cash payment methods to pay for goods and services. A further six million people with bank accounts (four million households) either choose cash over direct debit when paying because of limited access to banking services or because it is easier to manage household finances. This group represent 14.6 per cent of the UK population who in essence pay a financial penalty for not paying by direct debit. In Scotland it is estimated that 11 per cent of the population do not have a bank account, rising to 18 per cent for those on

low-incomes.² When it comes to making regular payments by cash or cheque, the Post Office is the most popular channel for many customers with almost 60 per cent paying their telephone bills using cash or cheque at their local Post Office branch³. The Post Office currently estimates that telecoms businesses are restricting the size of their potential market and could be losing potentially £165.2 million in lost sales per month by not accepting cash.

Regulators such as Ofgem⁴ (the UK regulator for gas and electricity) and Ofcom (the UK regulator for the communications industry) have both launched reviews into charging policies for low-income and other consumers. Ofgem is looking at among other areas tariffs for prepayment customers and those who do not pay their energy bill by direct debit, while Ofcom⁵ has issued a consultation on additional charges and is seeking responses by May 2008.

2.1 Household energy

Changing costs

The Scottish House Condition Survey (December 2007) has shown a rise in fuel poverty levels in recent years. Figures from the 2003/04, 2004/05 and 2005/06 reports showed that the percentage of people in fuel poverty (those households spending more than 10 per cent of their household income on heating their home) rose from 15 per cent (350,000 households) in 2003/04 to 18 per cent (419,000 households) in 2004/05 to 23 per cent (543,000 households) in 2005/06 – a rise of almost 200,000⁶. Given that household energy prices have risen considerably since the data was last produced, it would be a reasonable assumption that the number of households experiencing fuel poverty has increased. Recent estimates from Energywatch Scotland suggest that the number is closer to 650,000.⁷

More recent significant price rises mean average energy bills account for around 17 per cent of the income in poor pensioner households. The Government's maximum Winter Fuel Allowance (WFA) for 60 to 79 year olds, worth just over one-third of heating bills in 2003, now offsets 20 per cent of costs⁸. The 2008 Budget has set out the Government's intention to raise the WFA by 25 per cent for 60 to 79 year olds (to £250) and 33 per cent for over-80s (to £400).

Ofgem has reported "an uncomfortable lag" in wholesale energy price reductions being passed onto customers and a number of MPs have been strongly critical of such delays. Moreover, when energy prices have fallen in recent years, the biggest reductions tend to be passed on to direct debit customers. Pay-as-you-go customers (i.e. those using pre-payment meters) tend not to benefit from full or timely price reductions.

According to the major energy suppliers we interviewed, company pricing also reflects the strength of competitors in each part of the UK. However, in January 2008 Npower announced that their gas prices would vary *regionally* for the first time to reflect gas transportation costs. Taking higher wholesale costs into account its price rises would range from 15 per cent to almost 24 per cent, depending on distance from the key gas terminals. Consumer groups criticised the move claiming there is little evidence to justify large price variations on the grounds of location, but it has been widely expected other companies will follow.

² Cited in Making markets work for consumers in Scotland – everyone benefits, Consumer Switching behaviour and Attitudes in Key Markets, Scottish Consumer Council, Glasgow. 2008 (unpublished)

³ M2 Presswire, 26 July, 2007

⁴ Press Release, Ofgem launches probe into energy supply markets, Ofgem, 21 February 2008

⁵ Ofcom review of additional charges (February 2008) available at:

www.ofcom.org.uk/consult/condocs/addcharges/pes/

⁶ Scottish House Conditions Survey, Scottish Government, Edinburgh, December, 2007

⁷ Working for Scottish Consumers, Energywatch Scotland, 2007

⁸ Press Association Newsfile (2008) 'Research highlights millions plunged into fuel poverty', 7 March 7, 2008 (Nicky Burridge, Personal Finance Correspondent)

Pay as you go energy: Pre-payment Meters

Around two million low-income households in the UK have Pre-payment Meters (PPM) installed for gas and/or electricity, representing around one in three of all households with meters. PPM customers are three times more likely than others to be fuel poor. In the last year, almost two-thirds of new meters in the UK (366,000 in total) were installed to recover fuel debt, thus barring those consumers from switching to other suppliers.

This method of paying for energy is typically the most expensive, and can add up to £300 a year to bills. PPM customers pay more for each unit of gas and electricity plus more VAT at 5 per cent⁹. Energywatch argues that:

'The welcome actions taken by some suppliers to combat fuel poverty are offset by the extra costs and poorer service inflicted on those forced onto prepayment charges.'

'Pay as you go' is considered by suppliers as expensive to administer, for example due to recalibration of meters when unit prices change, with costs passed on to the consumer. Energywatch figures indicate the average cost to British Gas dual fuel customers who use pre-payment meters is £249 more than if they paid the cheapest tariff online by direct debit. Along with Npower, this is the highest differential of the six suppliers.

By transferring the risks to the customer, PAYG was considered an 'ideal' option by one supplier we interviewed. Driven largely as an energy efficiency measure, suppliers expected smart meters to become mainstream in homes in the next ten years. This was perceived as an effective way to give greater control over energy consumption, displayed in monetary terms rather than only kWh/thermal units. This should enable customers to switch from pre-payment to credit terms (i.e. subsequent billing for fuel used), and should make it easier to switch between suppliers. Another supplier agreed that smart metering would offer a better deal for PAYG customers, allowing faster recalibration and better spreading of debt repayment. For now, however, the *required* use of pre-payment as a debt management method carries stigma. Customers on low-incomes tend to face higher prices and significant barriers to switching.

The move towards smart meters was found to be of interest to almost half of Scots who responded to a recent survey by the Energy Saving Trust (1,200 people on various income levels took part across the UK). Scottish respondents found energy bills twice as difficult to understand as phone bills and four times more confusing than bank statements or credit card bills, with eight out of ten Scots saying they did not know what they were paying for their gas and electricity. The survey estimated that smart meters (which monitor how much each household appliance costs to run) could cost householders between £100 to £200 if they were mass produced, but save £110m a year on household energy bills.¹⁰

According to energywatch, PPM users are paying up to one-third more for the same energy than on-line customers (December 2007). The least expensive average pre-payment tariff is with Scottish Power (£946) and the most expensive is Npower's (£1,041). The *average* premium charged for using meters for both gas and electricity is £195 per year compared with the cheapest deals available, rising to just over £300 with one company in north Wales. In Scotland, the average prepayment penalty ranges from £121 (EDFE) and £170 (SSE) up to £273 (Npower) and £296 (Eon).

The watchdog estimates that the total prepayment penalty for meter users is £543 million more than the best on-line direct debit tariffs, while the cost of administering the meters is

⁹ Jason Strelitz and Claire Kober, *The Poverty Premium: How poor households pay more for essential goods and services*, Save the Children & Family Welfare Association, 2007

¹⁰ The Energy Saving Trust, 17 March 2008 available at <http://news.bbc.co.uk/go/em/fr/-/1/hi/scotland/7299378.stm>

less than half this (£247 million). Ofgem regards the average cost per household of administering inefficient and outdated meters to be around £85 per year if customers pay both gas and electricity by this method. *Thus, the net profit on prepayment customers is estimated to be £296 million per year (GB) and £34 million in Scotland (see Table 1).*

Most meter users have not been required to pay by this method by their supplier, but a growing number are in this position due to fuel debt. While it is necessary for suppliers to recover debt, it is unreasonable to do so at significantly higher prices than standard tariffs.

Table 1: Additional costs to pre-payment meter users

| | No. of PPM users | Average extra cost of PPM over on-line DD | Total extra cost to PPM users | Ofgem estimate of actual extra costs to serve | 'Excess' revenues from PPM users |
|--------------------|--------------------------|--|--------------------------------------|--|---|
| Gas | | | | | |
| Scotland | 185,263 (8% of GB) | £115 | £21m | £8m | £13m |
| GB | 2,289,669 | £108 | £247m | £97m | £150m |
| Electricity | | | | | |
| Scotland | 451,953 (12.8% of GB) | £88 | £40m | £19m | £21m |
| GB | 3,525,246 | £84 | £296m | £150m | £146m |
| Combined | | | | | |
| Scotland | ** | £203 | £61m | £27m | £34m |
| GB | ** | £192 | £543m | £247m | £296m |

Source: Energywatch (December 2007). Data from *Ofgem Social Obligations Report* (June 2007), Prices for medium user (Nov 2007)

Business models

The business model of one supplier sees PAYG customers managed in a separate profit and loss administrative account from other mid-market customers. Premium customers are treated separately again. Competition for premium customers is set to focus increasingly on green tariffs and the sale of energy efficient goods. It was reported to us that:

“The terms on offer to PAYG customers will inevitably reflect the degree of political force carried internally by those in charge of the PAYG market group”.

However, because customers are segmented within the company, there was no clear evidence of a ‘migration strategy’ to assist vulnerable customers to move onto other less costly ways of paying for energy. It was unclear if a competitor supplier interviewed segments its customer base internally in the same way.

2.2 Telecoms

Telephone and pay TV users may face additional charges from their provider over and above costs for the actual service. These charges can be triggered by a number of circumstances including:

- Making a late payment;
- Having a service restored after it has been restricted or suspended following late payment;
- Ending a contract within the specified minimum contract period – early termination fees.¹¹

Low-paid employees are more likely to take up telecom services than those working irregularly or on full benefits. Overall the majority of low-income consumers¹² take precautions to manage their expenditure by taking advantage of fixed-line packages and operating mobiles on a pay-as-you-go basis. Call charges for fixed lines are significantly cheaper than using PAYG mobiles.¹³ However, it is likely that many low-income consumers have PAYG mobiles because of the avoidance of contracts, ease of payment and the anonymity: there are no credit checks to go through with PAYG mobile phone and thus no risk of exclusion:

*‘Four in five (82 per cent) of mobile phone users aged under 65 from low-income households have a PAYG plan for their mobile, in contrast to 64 per cent of mobile phone users as a whole’.*¹⁴

2.3 Debt and disconnection

“It is our policy never to disconnect a vulnerable customer” (Energy supplier)

One of the energy companies interviewed told us there are better ways from the supplier’s perspective to manage the cost of debt repayment, such as adding debts to a pre-payment meter tariff and spreading the cost until cleared. It reported that it has had a policy for five years of not disconnecting vulnerable customers. It targets customers in arrears and assessed as being able to pay, and it uses penalty charges and the threat of ultimate disconnection if payment is not made. In practice, most of these customers tend to pay. The same supplier has introduced a service which aims to pro-actively identify vulnerable customers experiencing difficulty with bill payment before debts accumulate.

Energywatch has produced data (January 2008) on the number of households who have been disconnected because of rising levels of debt. Table 2 suggests that an estimated 9350 customers were disconnected due to fuel debt in 2007, an increase of over 6050 or 185 per cent on the 2004 level.¹⁵

¹¹ Consumer Bulletin (Issue 3, June 2007) Ofcom, London

¹² The definition of ‘low-income’ used is those consumers who live in households with an annual income of less than £11,500

¹³ ‘Low-income consumers and the communications market’, Annex 4, November 2007, Ofcom

¹⁴ ‘Low-income consumers and the communications market’, Annex 4, November 2007, Ofcom

¹⁵ *Serious energy debt taking toll of consumers*, Energywatch press release 25 January, 2008

Table 2: Number of disconnections: gas and electricity consumers (2004 – 2007)

| | 2004 (Actual) | 2005 (Actual) | 2006 (Actual) | 2007 (Estimated) |
|--|--------------------------|------------------------|--------------------------|-----------------------------|
| Disconnections due to debt – gas and electricity consumers | 3280 | 2913 (-11% on 2004) | 5117 (+56% on 2004) | 9350 (+185% on 2004) |

Comparable data for telecoms are not readily available. Table 3 shows Ofcom data on disconnections for the earlier period between 1998 and 2002. By 2005, it was estimated that BT disconnected around five per cent of residential customers (1 million) a year for non-payment of bills¹⁶ although reconnection figures were not available to calculate a comparable net figure.

Telecoms operators generally held the view that debt was not a major problem compared to other utilities or services. In one company interviewed the disconnection process lasts for up to 70 days from start to finish giving people the opportunity to work with credit control to clear outstanding debts. The cost of administering and managing debt was said not to be commercially viable for the company. It was not possible to break this figure down any further, although data from Ofcom suggested that 75 per cent of people who were disconnected from landline phones switched to mobile products.¹⁷

¹⁶ Universal Service Obligation: A Review, Ofcom (2005)

¹⁷ Low-income consumers and the future of communications regulation, Ofcom available at www.ofcomconsumerpanel.org.uk/files/information/lowincome/Seminar_report.pdf

Table 3: Number of net¹⁸ disconnections of landline customers for non-payment per 100 lines (January 1998 to June 2002)

| | BT | Eurobell | Kingston | ntl (NTL Cabletel) | Telewest |
|-----------------|------|----------|----------|--------------------|----------|
| Jan-June 1998* | 1.5 | * | 0.5 | 6.9 | 2.8 |
| Jul-Dec 1998* | 1.5 | * | 0.3 | 5.0 | 5.0 |
| Jan-June 1999* | 1.4 | * | 0.2 | 5.9 | 5.0 |
| Jul-Dec 1999 | 1.5 | 2.7 | 0.4 | 4.7 | 4.4 |
| Jan-June 2000* | 1.6 | 9.5 | 0.3 | * | 8.1 |
| Jul-Dec 2000* | 1.6 | 8.0 | 0.3 | * | * |
| Jan-June 2001* | 1.5 | 5.57 | 0.26 | * | * |
| Jul-Dec 2001*† | 1.6 | 2.5† | 0.2 | * | * |
| Jan-June 2002*† | 1.3 | 2.24† | 0.05 | * | 3.4† |
| Jul-Dec 2002* | 1.2 | * | 0.2 | * | 3.32 |
| Jan-Jun 2003*† | 1.41 | * | 0.07 | * | 2.7 |

*Some operators' data not submitted, or excluded

† Some operators' figures are projected, based on half the period.

Ofcom research (2004) examining the level of disconnections showed that customers who were disconnected were more likely than average to be in D/E social groups, had lower incomes and tended to be younger than average. A significant proportion of those who were disconnected claimed that this caused them a lot (37 per cent) or some (36 per cent) difficulties. Prior to disconnection only a quarter (24 per cent) used a scheme to help control or reduce costs. Two-thirds said that they had not been offered any scheme to help them manage their bill payments. Amongst those that had not taken up any of these schemes prior to disconnection over half (54 per cent) said that some sort of pre-pay scheme would have helped them to avoid disconnection.

2.4 Service standards and vulnerable consumers

Problems with energy utilities are now the fastest growing area of enquiry for the Scottish CAB service (Jan 2008). One energy supplier reported significant improvements in complaint handling, following a major upskilling of its workforce. It now encourages unhappy customers to seek early settlement of complaints through the Ombudsman rather than becoming engaged in lengthy dispute with the company. Citizens Advice Scotland confirmed this company has improved its performance, as measured by fewer complex complaints, but has achieved this from a very low base.

Like everyone else, low income consumers need access to high standards of customer services, as well as affordable products. Under the Consumers, Estate Agents and Redress Act 2007, the National Consumer Council (and in Scotland and Wales, the Scottish and Welsh Consumer Councils), energywatch and Postwatch will be merged to create the new

¹⁸ Net measured as disconnections minus reconnections.

National, Scottish and Welsh Consumer Councils later in 2008. The new body will have the remit and the critical mass to work across all sectors and champion the consumer interest in both private markets and public services.

With regard to complaints, the focus will be on ensuring that markets are made to work properly from the start, with suppliers getting it right in the first place. There will be both a spotlight and a challenge on suppliers to have in place clearer and more responsive service standards. There will also be new, statutory ombudsman schemes to enforce the best deal for consumers when companies get it wrong.

3. Unequal choices: switching tariffs, products or providers

The household energy, telecoms and retail markets offer a significant number of suppliers, and there is a widely held view that this equates to greater choice for consumers. For many households this is true. For low-income consumers, however, an increased range of suppliers does not necessarily mean that the marketplace will be more effective in providing for their needs. When markets function properly, consumers are able to identify which product is best for them and switch if they want to get a better deal. This should encourage companies to compete to retain existing customers (e.g. by offering more attractive tariffs) and attract new customers.¹⁹ For many low-income consumers, switching tariffs or providers may not offer any clear benefits as prices can remain high and restrictions may still apply (e.g. the need to clear existing debts), with many low-income families being denied access to cheaper deals (i.e. the full range of tariffs) because they lack bank accounts, access to the internet, prefer not to pay by direct debit on the grounds of controlling limited household budgets or have poor credit histories.

Over five years (2000-2005), research by the National Consumer Council found there has been a relatively large increase in the number of consumers in both the energy and fixed telephony markets who have switched providers, with gas followed by electricity having the highest switching rates. Ofgem (2007) identified that UK energy switching levels had hit 5 million, but whole groups of customers such as pensioners, those unemployed and low-income families were potentially not switching, leaving themselves in Ofgem's view vulnerable to price rises. In response Ofgem has launched *Energy Best Deal* with Citizens Advice to encourage more of these customers to switch by offering advice on how to reduce bills and explaining how they can switch.²⁰

3.1 Telecoms

Those switching fixed telephony provider represent a fairly low proportion of all customers, while the mobile phone market experiences limited switching. The younger and wealthier usually switch more than older or poorer consumers. This may be in part due to the fact that providers do not usually consider lower income consumers as worth competing over²¹.

Ofcom research found that just over one third of consumers in the fixed and mobile markets had switched *suppliers*, while 40 per cent of fixed line customers and 36 per cent of mobile customers had *changed tariff packages* with their current supplier. The majority of those surveyed had not switched supplier but many said they were able to negotiate better deals with their current supplier and monitor the market to find out about alternative offers. The study did not differentiate between customer groups by income, age, location or other factors.²² In a separate but related study consumers aged under 65 in low-income households were less likely to find it easy to make cost comparisons between different suppliers, and they were also less likely to find it easy to make quality comparisons between suppliers.²³

¹⁹ Alena Kozakova, '*Switched on to switching?* A survey of consumer behaviour and attitudes, 2000-2005, National Consumer Council, London available at http://www.ncc.org.uk/nccpdf/poldocs/NCC107rr_switching_findings.pdf

²⁰ Ofgem press release, Ref R/11, 2 April 2008

²¹ Alena Kozakova, '*Switched on to switching?* A survey of consumer behaviour and attitudes, 2000-2005, National Consumer Council, London available at http://www.ncc.org.uk/nccpdf/poldocs/NCC107rr_switching_findings.pdf

²² *The Consumer Experience*, November, 2006, Ofcom

²³ Low-income consumers and the future of communications regulation, Ofcom available at www.ofcom.gov.uk/files/information/lowincome/Seminar_report.pdf

3.2 Energy

A range of tailored approaches is required to enable vulnerable consumers to switch, since there are various forms of market vulnerability.²⁴ The key objective then for low-income vulnerable consumers is to enable them to make *an advantageous switch*, and not assume that all will be better off by switching.

With energy, switching was found to be most prevalent among higher social groups, particularly professional and managerial consumers. Among the groups least likely to switch were consumers claiming out-of-work benefits, those aged over 65, those living in rented accommodation and PPM users.²⁵

Frequent price changes and delays were found to inhibit confidence in switching. Only 11 per cent of social class DE use the internet as a source of information on switching, although telephone help lines are also available and survey data often does not include the option of turning to friends/relations for assistance. Energywatch reports the experience of major suppliers discriminating against pre-payment meter (PPM) consumers by refusing to accept them via price comparison websites. This points to a 'dearth of contestability in the PPM market' shielding suppliers from competitive pricing pressures in this area.

There appears to be a very low level of *awareness* among PPM customers about the premium they are paying. In workshops run by MORI for Ofgem, less than one in four PPM users knew theirs was not the cheapest method of paying. We know from other areas (e.g. doorstep credit and bill payment in cash) that some low-income consumers may still prefer to use more costly methods on the grounds of convenience and perceived control. But we don't know enough about the role of consumer preference versus constraint such as the requirement to use PPMs imposed by suppliers.

Energywatch states that, for elderly consumers in particular, sticking with a familiar provider may be rational. Their Priority Consumer Team has identified many older consumers on state pensions who cannot afford to properly heat their homes but are nonetheless reluctant to switch suppliers. Many of these consumers said they mistrusted supplier information and found price comparisons confusing. Its *'Are you missing out?'* campaign targeted older people and conducted 1400 price comparisons. It found:

- Two-thirds of consumers contacted could save money by switching either tariff or provider, with an average saving of £139 per year;
- Those who did switch (about one in six of those who took part) actually saved more: £177 on average (around £15 per month);
- The likelihood of switching rose with potential savings: one in three of those standing to save up to £300 and half of those saving up to £600 actually switched.

Energywatch concludes:

'If we are serious about including low-income, vulnerable consumers in the energy market, and increasing the proportion who make an advantageous switch, the market must offer products that are more amenable to the circumstances of this segment'.

It has called for the energy sector to:

- Offer better payment methods to allow more cost-effective budgeting than pre-payment offers currently, e.g. weekly direct debits, priority access to smart metering for PPM users as part of the Prime Minister's commitment to roll-out smart meters to

²⁴ *Vulnerable consumers and switching*, energywatch discussion paper for Ofgem Social Action Strategy Review Group, December 2007.

²⁵ *Switching Rates for Vulnerable Consumers* report for Ofgem by Ipsos Mori, 2007

all homes within ten years, and looking at the potential of new stored value technologies for managing accounts by mobile phone (see Section 5);

- Commit itself to the free movement of *all* consumers, e.g. full cooperation with switching services and a willingness to share historical consumption data;
- Ensure switching gateways are open to PPM users: they should not act as a filter by which suppliers can skim off more affluent consumers.²⁶

3.3 Food retail

Within the food retail sector it would be easy to assume that if consumers wanted to move their custom and shop at a different store the process would be more straightforward. However, for many low-income consumers, location and accessibility are as important as price. Across the country many large developments are situated adjacent to low-income communities but do little to address the issue of immediate access as they are often developed around a roads network that serves customers mainly using private transport. Site design may work against pedestrian access and connection with neighbouring communities.

Retail providers are only as good as their location for low-income consumers since transport availability and costs may negate any benefit derived from the product ranges carried. Larger retailers carrying greater product ranges can, to a great extent, cover a broad socio-economic spectrum of customers, although by virtue of their costs, product segmentation may steer low-income consumers towards those at the lower end of the scale thus limiting their choices. Many retail providers have as yet to develop particularly sophisticated marketing and promotion mechanisms to specifically serve the needs of low-income consumers or neighbourhoods. Recent developments such as home delivery for internet orders could be extended to telephone orders for registered customers, benefiting those with limited access to the best deals. Demand for older ideas like free shopper's bus might be tested again.

Providers of goods and services require to think differently about those described as low-income or vulnerable consumers. They are not a homogeneous group and adopting a one size-fits-all strategy in product development and marketing runs the risk of meeting the needs of no one in particular. The key objective for low-income vulnerable consumers is to provide a range of services to suit a variety of different spending powers. For those considering switching providers the process has to enable them to make *an advantageous switch* to a range of goods and services, be free of complex switching procedures and have easy to understand price and product information.

²⁶ *Vulnerable consumers and switching*, energywatch discussion paper for Ofgem Social Action Strategy Review Group, December 2007

4. Social tariffs: what is on offer for low-income consumers?

Around half of households living in poverty include someone in work (New Policy Institute 2006, 2007). Moreover, panel data shows that many households move in and out of poverty over a typical five-year period, with relatively small proportions either remaining persistently poor or escaping poverty altogether. Thus the focus for policy and practice should be on providing a range of services for consumers with differential and fluctuating spending powers, whether from earnings, tax credits or benefits, recognising that making payments in cash and on time is a legitimate way to budget, and should not be subject to penalty charges. Moreover, if all providers in a sector agreed to provide essential services regardless of payment method there would be no risk of adverse selection.

The main drivers that encourage providers of telecoms and household energy to serve this segment of the market appear to be based on one hand in legislation, and on the other in recognition of the essential nature of the service, rather than a considered approach that recognises its scale and spending potential. For example, the Universal Service Obligation (USO) in telecoms was introduced to combat social or economic exclusion from fixed line telephony. In the UK it is the responsibility of two major providers (BT and Kingston Communications) to ensure that basic fixed line services are available at an affordable price to all customers including special tariff schemes for low-income consumers. As Kingston's presence is mainly limited to the Hull area, BT is the main provider in Scotland. Ofcom's indicative estimate (2005) of the current costs of USO for BT suggests they are around £50-70m and the benefits are around £60m. At present, mobile phone providers are exempt from the USO, but most providers we spoke to in this study felt that, by offering a range of tariffs (both for contract/credit and pay as you go mobile phones), customers were able to choose a package that was right for them.

The exact definition of what constitutes a social tariff is vague, but for the purposes of this report we define it as any special payment arrangement devised with a view to benefiting particular groups in society. *Providers use different eligibility criteria, communication/targeting methods and discount rates, risking confusion for customers. It is by no means clear that those intended to benefit from social tariffs are even aware of them.*

4.1 Telecoms

Some suppliers of fixed line telephones offer some form of social tariff for certain of the least well off in society. Telecom providers have opted to target consumers on benefits as it is easier to determine income levels, even though this tends to exclude the working poor who make up around half of those living in poverty.

One service provider indicated that the ability to offer cross subsidies has eroded in recent years, and social tariffs are generally cost neutral resulting in little or no profit to the company. Another issue identified by the same company is that consumers may opt for a subsidised package and then link with another provider for a bundled package of telephone calls, TV and broadband.

Our research has indicated that in many instances providers do not openly advertise their social tariffs on literature included with bills or on their websites, preferring to let customer service advisers discuss a range of options with customers often through referrals from third party agencies (e.g. the Citizens Advice service). This could mean that those who could benefit don't find out about such tariffs until they fall behind with payments and debt management action begins. There is little evidence to date that companies offering these tariffs do much in the way of market research to identify the true scale of potential beneficiaries or have looked at how best to promote these to particular groups. Instead, interviews pointed to a view of take-up rates as based on informed consumers expressing little demand.

“The number of people opting for these schemes is fairly low. We assume this is because many customers may be satisfied with the packages they have currently.”
(Telecoms provider)

The same provider believed that customer behaviour had changed in recent years due to the widespread availability of pre-pay mobile phone handsets which are often a more convenient and affordable way for lower income consumers to manage costs. Indeed, a growing minority of consumers are opting out of having a landline phone altogether and using pre pay mobiles instead to control costs. This view was supported by many of the mobile operators we spoke to who said that the majority of their pre-pay customers tended to be on lower incomes. Mobile phones generally have a metering facility where customers can at any time identify the money they have left in their handsets to help them manage their payments.

Recognising the advantages of pre-pay telephony, BT offers a ‘pay as you go’ service (Pay & Call) with a twelve month minimum contract through a fixed line phone service. With Pay & Call customers have their own moneybox account which they can pay into whenever they wish. When they make a call, the cost of the call is automatically deducted from their moneybox account. The costs of rental and other services are also periodically deducted from the moneybox account. This allows customers more control over their spending. If they have an outstanding debt to BT, it lets them continue to have a full phone service while repaying their debts. Moneybox accounts can be topped up regularly, between a minimum of £5 and a maximum of £500 and, significantly, no additional charges are made when paying in cash. The service allows customers to top up twice per day using prescribed payment methods:

- BT Pay & Call Payment Card (which can be used at Paypoint outlets to pay by cash);
- Debit/Credit Card or Direct Debit.

This approach should hopefully be short term for many consumers before moving onto other packages once debts are cleared; or they find other offers which better suit their needs. However the Pay & Call option may soon be replaced by BT basic which will only be available to customers who receive one of these benefits:

- Income Support
- Income-based Job-Seeker's Allowance
- Guaranteed Pension Credit

The BT basic package has been described as a low-cost line rental scheme that has specifically been designed to help customers on low-incomes who would otherwise have difficulty affording a home phone service. This will be available later in 2008 to new BT customers.

The general position among both fixed line and mobile operators was summed up by one provider who told us:

“At the moment we are compliant with regulations but don’t do anything over and above requirements.” (Mobile phone company).

4.2 Energy

In addition to the government Winter Fuel Allowance for older households, some energy companies have offered winter rebates for both gas and electricity customers, recognising the impact of higher fuel costs during winter. For example, both Scottish Power and Scottish Gas have paid winter rebates. In the former case, cashback deals have been available and

pre-payment customers have been offered rebates. In 2005, Scottish Gas offered rebates to around 50,000 homes at a cost of £6.7 million, while payments of up to £90 were available in 2007 to 70,000 customers in receipt of key benefits.

All six of the major energy supply companies in the UK have introduced social tariffs in the last year. These are intended to offer target customer groups lower costs than the tariffs they are currently on. The Essentials tariff introduced by British Gas in February 2007 is a key example.

Example of energy social tariff: Essentials (British Gas/Scottish Gas)

The tariff was announced in February 2007 and is described by the company as the 'market-leading social tariff.' Measured by the number of target customers and the share of company turnover invested to date, it can be considered as the largest example of an energy social tariff. This is the cheapest tariff available to customers who are registered as 'vulnerable', especially those with pre-payment meters. The average estimated reduction in bills is 25 per cent (£24 per month) to those paying the most expensive pre-payment tariffs in cash. In Scotland, the annual saving for an eligible dual fuel customer would be around £240. Thus, significant price reductions are available to customers who would otherwise have needed to pay by direct debit.

British Gas has announced its plan to target the tariff at 750,000 of its most vulnerable customers across Britain and thus see their prepayment or quarterly credit tariffs aligned with its *standard* direct debit rate (i.e. not their cheapest tariff available to on-line direct debit customers). This represents significantly better value for money and has been described by family welfare NGOs as "a significant step forward." However, the social tariff does not match the 'best buy' deal available with the company. As discussed below, this is true for four of the six main suppliers. Another company interviewed noted its general advertising message to customers asks 'Are you on the best deal?' Switching to its social tariff would represent a much better deal for most vulnerable customers, but would not match the company's best tariff.

Eligibility and targeting

Vulnerability, and thus eligibility for social tariffs, is determined typically by various passport benefits, although some suppliers intend to review the basis for eligibility within the next year. This is distinct from the Priority Service Register which consumers may self-refer to and which offers eligible customers gas safety checks and Braille services for example. Assuming maximum take-up among vulnerable customers, the maximum cost of Essentials to British Gas would be £90 million. Extrapolated across the six main suppliers with an equivalent voluntary commitment relative to their customer bases, a total of 2.26 million eligible customers would benefit at a cost of around £275 million. For comparative purposes only, this is almost the same as the net profit made from pre-payment customers. According to energywatch, this would represent £6 for every gas and electricity account in the UK each year²⁷.

There appears to be little proactive marketing of energy social tariffs. Outbound calling to check which benefits customers are claiming was regarded by companies interviewed as impossible due to Data Protection laws. Thus payment difficulties and accumulating debt serve, in practice, as the main trigger to be moved onto the Essentials tariff, typically via referrals from the Citizens Advice service. One supplier explained that it employs Community Liaison Officers working with Citizens Advice and Money Advice offices to

²⁷ Richard Bates, *A Social Responsibility*, Energywatch consultation on the nature of social tariffs in the energy market, Energywatch, May 2007

provide a 'dedicated service.' However, this is not available directly to the public and takes largely the same responsive rather than preventative approach as others.

Suppliers can identify how many customers are on their social tariffs, but it is less clear how many more could be eligible (i.e. the effective take-up rate) since not all have set targets. Other customers may be claiming qualifying benefits but not aware of the social tariff, or are eligible for passport benefits but not claiming them. British Gas has supported research on the scale of unclaimed benefits and the value of benefit take-up activity by the Centre for Analysis of Social Exclusion at the London School of Economics.

Those just above benefits thresholds, those on other forms of support (e.g. in-work tax credits) and customers using pre-payment meters (especially those required to do so as a means of debt repayment) tend to be hardest hit by price rises since the range of options that reduce costs for other customers are harder to access – namely, switching to a social tariff on grounds of vulnerability; switching to on-line and/or direct debit payment for dual fuel; and switching providers.

Published evidence on energy social tariffs

Despite many essential service providers introducing social tariffs we know relatively little about their impact (Kempson and Collard, 2006). We can expect the picture to become clearer gradually as more research is undertaken by regulatory bodies and others.

For example, research commissioned by energywatch and conducted by Cornwall Energy Associates (CEA)²⁸ found that none of the social tariffs offered by the big six energy companies are cheaper than the best buy deals on the market. The study found that they have spent £28 million (0.1 per cent of their annual turnover) subsidising bills through social tariffs to date. Across Britain, between 400,000 and 540,000 households are receiving discounts through social tariffs²⁹. This is equivalent to between one in eight and one in ten of those considered to be in fuel poverty, although it is not clear that assistance is fully targeted in this way. Moreover, uSwitch reports that even once suppliers have boosted the number of people who are on social tariffs, they would still be helping less than one million customers. This is clearly a contested area, since British Gas alone states it is targeting 750,000 vulnerable customers.

According to the CEA study, Npower invests by far the least, followed by Scottish Power. British Gas provides the most assistance. *The amount invested to date in social tariffs represents less than 10 per cent of the net profits made from prepayment customers, after running costs have been taken into account.*

Contrary to claims made by some of the companies we interviewed, social tariffs were found to be more expensive than the best tariffs offered by the same company: ranging from £19 more with Scottish Power to £96 with British Gas. This means that although British Gas invests most as a share of turnover, it still prices its social tariff higher than the best deal received by online direct debit customers. In contrast, EDF Energy's social tariff offered the greatest saving (£151 less than their next best deal), followed by Scottish & Southern Energy (£71 cheaper). In addition, one provider expects customers on its social tariff to pay by direct debit, effectively excluding those who do not have a bank account³⁰. *On this basis, customers with a majority of the big companies cannot be sure they are on the best rate available by moving to a social tariff.*

²⁸ Cornwall Energy Associates (2008) Proportionality of Social Tariffs and Rebates, unpublished report to energywatch, reported in 'Energy suppliers are 'profiteering from poor people', *The Independent*, 15 January.

²⁹ Estimates vary significantly: the CEA/energywatch study (December 2007) reports 542,000 customers on social tariffs, while uSwitch (March 2008) reports fewer than 400,000.

³⁰ Cornwall Energy Associates (2008) Proportionality of Social Tariffs and Rebates, unpublished report to energywatch, reported in 'Energy suppliers are 'profiteering from poor people', *The Independent*, 15 January.

In its consultation on energy social tariffs³¹, energywatch proposed that suppliers should be obliged by law to offer Energy Assistance Packages meeting minimum standards and comprising:

- A social tariff to address the price of energy;
- Heating and energy efficiency improvements addressed through EEC Priority Group measures, and cross-referral with Warm Front and its devolved equivalents;
- Cross-referral with DWP-sponsored benefit entitlement checks to maximise household income.

To make such a policy effective, they call for:

- Binding targets on take-up, to be monitored by Ofgem;
- Eligibility criteria to be evaluated by government and adopted by all suppliers;
- DWP and HMRC to become fully 'open for business' to suppliers to enable better targeting of eligible customers;
- Social tariffs to be set at the lowest price offered by the supplier, *irrespective of payment method*;
- Social tariffs to be offered until all relevant parts of the Energy Assistance Package have been deployed and the household has moved – as far as practical – out of fuel poverty. Entitlement of 12 or 24 months is suggested before being reviewed.

Uswitch, the on-line price comparison service, has also endorsed an industry-wide standard on social tariffs, clearer eligibility criteria and a guarantee from suppliers that customers on social tariffs will always be paying the lowest available price.

Pressure from various Westminster Select Committees for greater regulation of energy companies to ensure all offer a social tariff meeting an agreed standard was considered by one company interviewed as 'fatuous,' given that most have already introduced a social tariff or were planning to without being obliged to. Another company felt that providers were, as whole, *'coming up to the mark voluntarily'* on social tariffs. It emphasised the role of energy efficiency health checks and improvements for vulnerable customers and told us how it was going beyond what is required by the Energy Efficiency Commitment (EEC) in its work with local government partners. The trade body, the Energy Retail Association (ERA), has stated that no other business sector voluntarily provides more help for low-income and vulnerable households, pointing out in addition that not all pre-payment meters users are low-income or vulnerable.

Nonetheless, if it is perceived that any parts of the sector are not doing enough, the threat of further regulation was believed by the suppliers we interviewed to be real. Ofgem's inquiry into the functioning of energy markets for domestic customers (announced in February 2008) marks an about-turn from its position just a month earlier, when it sought to assure the UK Government that there was no evidence of price fixing or anti-competitive practice in the sector. Moreover, the 2008 Budget announced the Government's expectation that energy suppliers would raise their total investment in social tariffs to £150 million to assist vulnerable consumers.³²

Initial scrutiny of action taken by energy suppliers suggests that, judged by value for money, pro-active targeting and take-up rates, the impact of social tariffs is still in question. Although we can identify some promising developments led by energy companies, there is also evidence of complacency and special pleading towards government against doing more to

³¹ *A Social Responsibility? The energywatch consultation on the nature of social tariffs in the energy market* (May 2007).

³² *Stability and opportunity: building a strong, sustainable future*, HM Treasury, Budget 2008, Page 66, Para 4.34 12 March 2008, available at: http://www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_index.cfm

tackle fuel poverty. We believe it is thus too early to identify genuinely good practice which would need to be measured in terms of outcomes for consumers.

To make the range of social or special tariffs more widely known and used will take a more concerted effort to promote them more widely. At present many low-income consumers are only aware of these once they end up in financial difficulty, rather than by being assessed early as a means of preventing hardship. Assessing the circumstances of each potentially eligible customer without recourse to reliable data could be claimed to be too resource intensive for suppliers if attempted on a large scale. However, this approach would be helped if relationships with intermediary agencies and Government departments such as the Department of Work and Pensions, and HM Revenue and Customs (who administer tax credits for low-income families) were more effective. Such forms of assistance could offer temporary help to consumers in times of need, with regular assessment built in to review changing financial circumstances as households move both in and out of eligibility.

5. Alternative ways to pay

'The current trend in the US of creating products aimed at lower income consumers began in the 1990s with the launch of pre-paid mobile phones, which were specifically aimed at non-creditworthy people who could not get a landline telephone. Not only were the phones successful, they showed companies that there was a large segment of the population willing to pay for a service before they got it, exactly the inverse of how most service delivery works'.³³

In this section we explore alternatives to cash and direct debit payment, such as pre-paid cards and mobile technology as ways in which low-income consumers can pay bills on time and therefore reduce the cost associated with other payment methods. We also consider alternative places to pay, in particular automated retail kiosks. Much of the evidence drawn upon is from North America and the Far East, given the faster adoption of some technologies there compared with the UK. Some emerging evidence from the UK is also considered where appropriate.

5.1 Pre-paid cards

Pre-paid cards offer a way for consumers to load money onto cards that can be used in similar ways to debit and credit cards, but with no credit checks and no need to have a bank account. Research has found that making transactions more convenient along with retailers and other service providers accepting a variety of pre-paid cards has increased both demand and usage. For example, pre-paid card sales at convenience stores in the United States rose by over two-thirds in 2005 and the entire pre-paid market is thought to be worth more than \$2.5 trillion. As well as using the cards in daily transactions consumers can pay bills, shop online or get cash from ATMs.

Estimates suggest considerable growth in this area will take place across Europe and the United States. A 110 per cent increase in the pre-paid industry is projected between 2006 and 2010 in Europe, with Europeans expected to spend €75 billion on pre-paid cards by 2010. Within the United States, estimates suggest that pre-paid card spending will reach US \$178 billion by 2010.³⁴ Although this approach might appear to be easier for lower income consumers to manage their finances, without the hurdles introduced by the banking system, caution is needed when considering the overall cost of buying or topping up cards.

One example from the UK targeted at lower-income consumers is 'Prime Card' (IDT Finance) which is available for instant issue in 16,000 stores across the United Kingdom. The distribution network includes both over-the-counter and online options, allowing the company to target people who are either unbanked or migrants or both. This pre-paid card is not linked to the customer's existing banking or financial data. This feature has made it useful for online shopping, protecting against identity theft and online fraud in relation to existing bank accounts. Both disposable and reloadable cards are available and there is an option to have a second card on the same account.

The Prime Card is currently available for sale to adults over 18 but there are no age restrictions on use. The card can be loaded on purchase with a value between £10 and £150 in-store (or up to £500 online). There is a £3 fee on the purchase of any card. The Prime card can be upgraded to a reloadable card for £1.95 (subject to the application to upgrade being accepted), allowing customers to have a maximum balance of up to £5,000 on a card at any one time. A second card can be purchased for an additional £5 fee. Transaction and usage fees apply. For example:

³³ Constantine von Hoffman, *For Some Marketers, Low-income Is Hot*, September 2006
http://www.brandweek.com/bw/news/recent_display.jsp?vnu_content_id=1003119803

³⁴ Pre-paid Cards Asia Summit 2008 available at <http://www.terrapinn.com/2008/pre-paid/conf.stm>

- A fee of at least 50 pence and no more than £1 is charged for every transaction; a monthly maintenance fee of £2 applies to disposable cards after the first three months;
- A telephone registration fee of £1 applies;
- It costs £1.95 to upgrade to a reloadable card; each reload incurs a fee of 2 per cent (and no less than 80 pence);
- Each cash withdrawal from an ATM (possible with upgraded cards) costs 75 pence; *and*
- If an account has not been used for three months, a dormancy fee of £2.95 per month applies.

Example: Casual worker using pre-paid card (Prime Card)

Andrew is a 45 year old labourer, who works on a series of casual contracts. He closed his bank account some years ago due to being overdrawn by a small amount and incurring significant charges. He and his wife Emma prefer to budget and pay bills in cash, even though this costs more. Andrew is interested in a pre-paid card for shopping and paying bills. Because there is no risk of going overdrawn, he is willing to use a pre-paid card as a secure way to store money.

He applies for a Prime Card by telephone, successfully upgrades to a reloadable card and buys a second card for Emma. In the first month, Andrew and Emma use the card 12 times to withdraw cash and reload it twice.

The transaction fees to date come to £35.95, a few pence more than the bank charges Andrew experienced previously.

To be effective for low-income consumers, pre-paid cards need to be widely available. Ease of transferring funds to the pre-paid card account from a growing number of locations and through a variety of methods, at minimal cost is an important factor. Pre-paid cards currently carry no risk of incurring debt as customers cannot spend beyond the limit of their card. Theft is the main risk for consumers. This sector is still too young to draw firm conclusions and we do not know how representative the above example is. However, it demonstrates that transaction and usage charges on cards issued by private suppliers (as distinct from cards issued by government and employers) could leave vulnerable consumers in an even worse position if safeguards and costs are not properly controlled.

5.2 Using preloaded cards to pay benefits: North American trends

The U.S. Department of the Treasury's Financial Management Service (FMS) has designated a leading American bank as its financial agent in an initiative to offer millions of unbanked Americans the option of using a pre-paid debit card (Direct Express) as a way of receiving Social Security and other federal benefit payments. It is estimated that if every unbanked federal cheque recipient signed up to use the card, taxpayers would save about \$44 million per year in reduced transaction costs and fraud. Card holders will be able to access their money at ATMs and financial institutions nationwide. They will be able to use their card to get cash back and make purchases at retail locations, as well as pay bills and make purchases online. In addition, these accounts are PIN-protected, insured and subject to federal consumer protection regulation.³⁵

In a state-wide initiative, debit cards are now being distributed to new unemployment benefit recipients in Pennsylvania who choose not to be paid by direct deposits.³⁶ The agency issuing the cards has suggested that this approach would increase security, reduce fraud and provide instant, 24-hour access to cash without surcharges at nearly 2,400 automatic teller machines in Pennsylvania and more than 18,000 ATMs nationwide (assuming

³⁵ http://www.fms.treas.gov/news/press/financial_agent.html

³⁶ Press Release 15 October 2007, <http://www.governor.state.pa.us/governor/cwp/view.asp?a=1115&q=454492>

customers can get access to non fee-charging ATMs). Benefit recipients without bank accounts will no longer have to rely on expensive cheque cashing services and can obtain account information online through a secure website, or a 24-hour/seven-day free phone number. While cashing benefit cheques will continue, eventually this will no longer be an option for recipients. This trend is also evident in Canada where the province of Alberta has introduced government-issued debit cards to pay benefits and the city of Victoria in British Columbia plans to follow suit.³⁷

In the state of Wisconsin, providers have said that the popularity of a pilot programme called the Wisconsin Support Collections Debit Card has led to roll-out earlier than expected to enable the state to quickly and conveniently distribute child support payments to parents. A review of the pilot suggested that more than 70 percent of the cards issued to parents have been activated successfully, while parents in non-pilot counties were said to have expressed demand to receive cards as well. Parents will no longer have to wait for cheques to arrive in the mail or pay expensive cheque cashing fees if unbanked. Each time a support payment is made, the amount is posted automatically to the debit card. The cards can also be used at ATM machines, although the downside is that that some fees might apply.³⁸

5.3 Using pre-paid cards to pay wages

Increasingly, employers in the United States are issuing pre-paid payroll cards instead of paying staff with cash or cheques. Payroll cards allow employees to access their pay through various means, depending on the particular product. Wages are deposited to the payroll card account via direct deposit and the employee uses the card to withdraw cash at an ATM or to purchase goods and services at PIN-based point of sale terminals. One of the distinguishing features of bank-issued payroll cards is that generally they are not marketed directly to consumers. Instead, banks market the cards to employers, who in turn encourage employees to use a payroll card to receive their wages.

*'Alongside being able to make purchases or getting cash back at retail outlets, using the existing credit card network most banks also provide cardholders with a monthly statement to keep track of spending, which many of those without a bank account have no easy way to do.'*³⁹

Some Latin American governments are now encouraging employers to pay their employees via payroll cards. This extended use of payroll cards has resulted in Latin American banks rolling out POS (Point of Sale) terminals to small merchants and convenience stores to encourage people to use payroll cards at the POS, rather than withdrawing cash from ATMs. For example, in Mexico the number of POS terminals has doubled from 350,000 two years ago, due to a government programme to encourage firms to issue payroll cards.⁴⁰

5.4 New payment technology

The growth of pre-paid mobile phones is an example of this approach in practice. Pre-payment is one way of including those previously excluded from certain goods and services, offering greater control to the consumer and minimising the risk to providers. Trials are under way mainly outside the UK to allow consumers to use mobile handsets to pay for purchases at various points of sale. If the trend continues, is proven to work, consumers adapt to this new approach, costs are kept down and mobile technology advances, some commentators have suggested consumers would be able to use their mobile phone in a similar way to using a credit or debit card.

³⁷ The Vancouver Sun , December 6, 2007 NEWS; Pg. A1

³⁸ Press Release, The Wisconsin Department of Workforce Development, November 2007

³⁹ Samuel Frumkin, William Reeves, and Barry Wides, Insights, Community Affairs Department, Office of the Comptroller of the Currency, Washington DC, June 2005. <http://www.occ.treasury.gov/Cdd/payrollcards.pdf>

⁴⁰ Card International , October 6, 2007 , NEWS BRIEF; Pg. 6

In the UK the growth of mobile phone ownership is continuing to erode landline use as nearly one in ten UK households rely solely on mobile phones compared to seven per cent who only have a landline.⁴¹ Ofcom has also identified that around 80 per cent of adults in the UK have mobile phones and that Scotland has a relatively high dependence on mobile-only phone use (particularly PAYG mobiles) at 13 per cent of households.

Thus many low-income consumers and households potentially have access to this as an alternative route into payments and transactions. Whether availability will translate into services being marketed to PAYG mobile customers or low-income consumers preferring to use this option are entirely distinct questions. It is very likely that the first wave of mobile payment initiatives will target contract mobile users with bank accounts – that is, those already included within the financial service system. Technology exists to include more vulnerable customers – but does the market imperative exist to do so?

Four banks (Royal Bank of Scotland, Alliance & Leicester, HSBC and First Direct), and two mobile phone operators (Vodafone and Orange) have signed up to mobile banking technology in the UK. Bank statements can now be sent via mobile phones to 13 million customers. Alliance & Leicester plans to allow customers to make bank transfers and 'peer-to-peer' payments by mobile.

Contactless cards

Many industries in Europe are starting to use 'contactless applications' in increasing numbers when paying for goods in shops, fares on public transport and parking. This suggests that mobile phones may soon be complementary to cash and service cards. Recent announcements include the launch of contactless terminals in London, combining payment card, credit card and pre-paid Oyster Cards on the city's transport network. Trials conducted in various countries suggest that consumers like the simplicity of using mobile phones to access and securely pay for entertainment, information and services while on the move. The contactless portion of the cards will be able to handle payments of £10 or less.⁴²

Halifax has issued its first contactless payment cards to customers. The group said the new 'payWave' debit cards would be sent to around 25,000 customers in London who were taking part in the first phase of its contactless payment roll-out. Again, the cards will enable customers to pay for items costing up to £10 by waving their card in front of a scanner. The card will also act as a normal debit card for purchasing items of more than £10 and can be used to withdraw cash at ATMs. The group plans to roll-out the contactless payment technology across the rest of the UK within a year.⁴³

In 2007, around 10.4 billion payments of less than £5 were made in the UK, more than 96 per cent of which were made using cash. Payments body APACS estimates that there will be more than five million contactless payment cards in circulation by the end of 2008, with cards being accepted at more than 100,000 retailers.

Payment on the go: mobile transactions

A new range of banking services designed for use on mobile phones has been heralded the 'm-commerce' era. The trend is being led by institutions in the Philippines, Malaysia, Kenya and South Africa, leapfrogging traditional banking processes and infrastructure in favour of using the mobile phone. Initiatives in mobile retail banking, so far, have enabled customers

⁴¹ Which Website, 23 August 2007 – available at http://www.which.co.uk/reports_and_campaigns/audio_visual/reports/phones/mobiles_erode_landlines_news_article_557_120046.jsp

⁴² <http://www.contactlessnews.com/news/2008/02/14/london-2012-olympics-might-be-cash-free/>

⁴³ <http://www.contactlessnews.com/news/2007/11/12/halifax-issues-contactless-cards/>

to check balances, pay bills, transfer funds between accounts and send remittances to other countries. Typically, these services are provided by banks to customers using mobile Web browser capabilities.

The leap to the mobile handset as a dominant payment device is still several years away in Europe and North America. However there is a view in the USA that slow-moving banks may find their customer bases and payment revenues at risk.⁴⁴ Some US commentators are suggesting that mobile phone banking will substantially change the banking landscape over the next few years. Factors ranging from increasing consumer acceptance of and experience with mobile devices and online banking and improved technology solutions provided by mobile banking suppliers, are converging to create an environment where mobile banking is moving towards full development. Financial institutions are considered to be on the verge of tapping the potential of wireless networks and mobile devices to better serve their customers:

Partnerships between financial services and technology developers also appear to be growing. For example, Emirates Bank is working with Californian technology consultancy Infospan to create a stored, rechargeable value card, allowing customers to send and receive funds via ATMs, call centres and text messaging.⁴⁵ Other developments include Etisalat (an m-banking firm in the Philippines) partnering with Smart Communications to introduce contactless technology, allowing users to make day-to-day payments by 'waving' mobile phones near a receiving device at bus stations, retail outlets, and cinemas.

A report for the Centre for Financial Services Innovation has suggested that:

*'The next wave of developments will enable transactions such as savings opportunities and access to moderately priced credit. For under-banked users of mobile financial services...the ability to easily load money to their phones may prove as important as the ability to spend and transfer funds. Customers without bank accounts or credit cards will require alternative load mechanisms. Options might include direct payroll deposit, designated kiosks or "reverse ATMs" that accept cash, point-of-sale loads through partnerships with retailers or pre-paid load networks.'*⁴⁶

The Royal Bank of Scotland (RBS) has announced plans to become the first bank to pioneer mobile phone debit payments in the UK. Its 'Tap and Go' Mobile Phone payment option will be tested in 2008. Participants in the RBS trial place their mobile phone on a contactless payment terminal and their transaction (up to the value of £10) is processed in seconds. This means that people will be able to buy everyday goods without opening their wallet or purse. Mobile Phone payments use short range, wireless technology called Near Field Communication (NFC) to carry out secure 'Contactless' payments. When the mobile phone is placed in very close proximity to the Contactless terminal, it transmits data from the customer's mobile phone to the retailer's card reader.⁴⁷

Innovation on this scale presents both challenges and opportunities for regulators. Policy will determine what processes and practices are legally permitted, but could also determine which business models are economically feasible, and how far they will go in reaching those least well off in society. The role of regulation will also be important in determining where responsibility lies in ensuring security of transactions. Consumer protection and confidence is essential. The technology will take time to mature requiring banks, credit card issuers, mobile phone carriers and retailers to either cooperate or be forced to act by 'disruptive'

⁴⁴ Bank Systems and Technology, 1 November 2007, Payments watch, Mobile Payments, Pg 20

⁴⁵ Gulf News October 4, 2007

⁴⁶ Caroline Boyd and Katy Jacob, Mobile Financial Services and the Underbanked: Opportunities and Challenges for Mbanking and Mpayments, Federal Reserve Bank of Chicago, for the Centre for Financial Services Innovation, April 2006.

⁴⁷ <http://www.contactlessnews.com/news/2007/11/26/small-mobile-phone-debit-payment-trial-starting/>

competitors entering the market. However, progress may be faster than we realise. For example, 15 million subscribers now use mobile based 'wallet phones' designed in Tokyo. There is also a widely held view that many of the technologies are transitional, paving the way to wider use of the wallet phone.

Canada is also poised to introduce so-called 'Wave-pay-go' technology. The Royal Bank of Canada is collaborating with Visa Canada to test technology that allows mobile phones embedded with special microchips to act as mobile wallets, letting people literally pay by phone. Consumers will be able to wave their mobile phone at the checkout reader without using a pin or password to pay for their goods. The Ontario-based pilot is expected to be completed in 2008 when the Bank will determine how to launch the service commercially. There are plans for this service to carry no additional cost to the mobile phone user and the system will be limited, initially, to transactions of \$25 or less.⁴⁸

'There's increasing evidence that the availability of financial services correlates strongly with economic growth and poverty alleviation. Mobile phones are important because they can offer bank-like services without the need for expensive branch offices. A mobile wallet can become, in essence, a virtual bank account. Salaries or government benefits might be deposited directly into mobile wallets, where they could be stored until needed for withdrawal or transfer'.⁴⁹

To be successful some commentators have suggested partnerships between handset and software developers, financial institutions, retailers, and credit/debit card providers are necessary as no single player can create a sustainable model by going it alone. Consumer demand in the UK is only likely to increase sustainably if paying by mobile phone is demonstrated to be convenient, secure and no more costly than alternative payment forms.

Significant advances are being seen in the area of technology, particularly with the use of mobile phones in helping those previously without access to financial and other services. Mobile operators appear to have both the reach and the critical mass of customers. How far these developments will be able to compete with or even replace traditional or more complex services offered by banks and other providers remains to be seen. However, technology, including mobile telephony, may offer developing areas of the world access to services where traditional financial channels (e.g. banking infrastructure) are not thought to be viable.

In rural and remote areas of Scotland, banks have taken different approaches to serving customers, one having made a commitment to retain its existing branches, while another has embarked on a course of closing branches while relying in part on a Post Office network that is itself at risk. It is hard to envisage mobile telephony and on-line services meeting the needs of consumers who need or prefer to deal face-to-face and in cash. These could however, complement existing services if mobile telephone networks and broadband coverage/speed were to improve significantly.

Innovation and exploiting developments in technology in both service delivery and processing transactions should be a high priority for any organisation. Using technology as a way of innovating business processes to include groups previously excluded from particular services has to be considered carefully. Furthermore, a growing body of research suggests communications are an essential element of economic regeneration:

⁴⁸ The Halifax Daily News, Friday November 2, 2007, MONEY; Pg. 19

⁴⁹ CNN.com/world business 10 December, 2007 available

at:<http://edition.cnn.com/2007/BUSINESS/12/10/digital.mobile.money/index.html>

*"Investment in telecoms generates a growth dividend because the spread of telecoms reduces costs of interaction, expands market boundaries and enormously expands information flows."*⁵⁰

We are struck by the optimistic reading of future trends offered by technology advocates. It is clear that significant benefits are likely to flow to those companies – and even governments – which invest in new technologies. The majority of consumers are likely to benefit from greater convenience, but not necessarily lower transaction costs. For example, charges for mobile banking arising from web use may be significant. The key consideration for policy-makers should be the whole public interest, not benefit to particular customer segments. Among the questions to be addressed are:

- Who is the expected 'growth dividend' for?
- Will the almost universal coverage of mobile phones mean PAYG customers are included in new forms of financial service, or will those without advanced handsets, bank accounts or positive credit scores be kept out?
- Will security be compromised by the emergence of pre-paid cards, contactless and mobile payment methods?
- How will regulation be exercised in the face of growing convergence between, for example, banks, telecom companies and retailers?
- How will operating standards and safeguards be developed to allow systems and providers to communicate with one another, while at the same time ensure the overall integrity of the technology to protect sensitive consumer data?

5.5. Alternative Places to Pay

Chicago and Milwaukee are the first cities in the USA to introduce Pay-Ease Automated Commerce Machines for municipal payments. The kiosks are housed in selected city bill-payment centres and accept cash, cheques, credit cards and debit cards. Residents can only pay bills for gas, electricity and water at the machines because they do not dispense cash. The kiosks are part of the city's goal to expand payment options and provide convenience for citizens.⁵¹ The next wave of automated retail kiosks is being rolled out in Wisconsin and Illinois. Described as the next generation ATM, they will dispense cash and pre-paid cards, sell mobile phones and phone minutes, and accept bill payments. Customers key in their transactions on a touch screen and see the results on a display screen that also serves as a "billboard" for advertisements. However there are mixed views on the readiness of the market to adapt to this type of technology and a lack of information to date on the ease of use and longer term viability of such approaches, particularly for lower-income consumers.⁵²

⁵⁰ The Impact of Mobile Phones on Economic Growth in Developing Countries (with Prof. L. Waverman, with M Meschi and M Fuss, featured in The Economics Focus section of The Economist, March 12, 2005); Quoted in the Guardian, October 29, 2007, pg 27

⁵¹ ATM and Debit News, 1 November 2007 KIOSK NEWS; Pg. 5 Vol. 7 No. 40

⁵² ATM and Debit News, January 17, 2008 PRE-PAID NEWS; Pg. 5 Vol. 8 No. 2

6. Alternative ways to assess credit worthiness

At present many commercial organisations in the UK use credit reference agencies to determine the financial viability of new customers. A credit reference agency provides consumer credit information on individual borrowers which lenders and providers use to assess credit worthiness or their ability to pay bills or repay loans. The agencies collect personal financial data on individuals from *data furnishers* with which they have a relationship. Data furnishers can be businesses, debt collection agencies, public institutions and the courts (public records) that a consumer has engaged with. The resulting information is made available on request to contributing organisations for the purposes of credit assessment and credit scoring. This is carried out by applying a calculation to assess the likelihood that the consumer will be able to pay bills or repay debts.

Credit reports are becoming a vital factor in the purchasing decisions of many low-income consumers. Consumers with high credit scores are generally allowed access to a wide range of goods and services, while those who are 'credit challenged' have more limited options. Customers with poor credit histories and little or no savings will at times have legitimate borrowing needs caused by unexpected costs or fluctuating incomes. There does not appear to be a recognised or easy way to help people move from having a low credit score to a higher rating and help them overcome barriers to accessing finance, goods and services in ways they can afford to repay.

In a study on methods to determine credit-worthiness, the Brookings Institution *Urban Markets Initiative* is considering the impact of using new and readily available information such as utility payment history to calculate credit scores; a development they believe could bring millions of previously excluded individuals into the economic mainstream. The Urban Markets Initiative is currently working with credit reporting agencies, lenders, telecoms companies, utility companies and researchers to investigate the opportunity to use "alternative" or "non-traditional" data, including payment obligations such as rent, gas, electricity, insurance, and other recurring obligations, to evaluate the risk profile more accurately.⁵³ If people consistently make cash payments on time to utility companies and other providers this would be taken into account when determining credit ratings. In a related study, there appeared to be market interest in using alternative payment data⁵⁴. One example is Payment Reporting Builds Credit (PRBC), which uses self-reported but verified alternative payment information, thus sidestepping legal and regulatory barriers and accessing payment information not covered in standard credit reports:

*'Although small in number, lenders are beginning to use this type of approach in credit decision-making, suggesting that a demand for alternative scoring models exists.'*⁵⁵

Credit and information solutions provider Experian, from its base in California, is working to create a pool of alternative data sources for financial institutions to use. The aim is to develop an alternative consumer report to help consumers with limited or poor credit ratings. Among the data Experian are considering are utility records, pre-paid card histories, lease information and, for those with a bank account but no history of borrowing, deposit account/checking account data. Experian is piloting this approach in the Los Angeles area with banks and credit unions where they are aggregating information not traditionally reported in its credit profiles to see if it provides financial and other institutions with an adequate risk profile on individuals.⁵⁶

⁵³ Increasing Access to Affordable Mainstream Credit Using Alternative Data, The Brookings Institute. <http://www.brookings.edu/metro/umi/collaboratory/creditscoring.htm>

⁵⁴ Michael A. Turner, Alyssa Stewart Lee, Ann Schnare, Robin Varghese, and Patrick D. Walker. *Give Credit Where Credit is Due, Increasing Access to Affordable Mainstream Credit Using Alternative Data*, The Brookings Institute and the Political and Economic Research Council, December 2006 http://www.brookings.edu/metro/umi/pubs/20061218_givecredit.htm See also Giving Underserved Consumers Better Access to the Credit System, Information Policy Institute, July 2005

⁵⁵ Ibid

⁵⁶ Maria Bruno-Britz, Targeting the Unbanked/Underbanked With the Right Solutions, July 2006 <http://www.banktech.com/news/showArticle.jhtml?articleID=191203058&pgno=3>

In one study looking at obtaining alternative credit scores, some important findings emerged:

- An alternative score has meaningful predictive and economic value to lenders/providers extending credit to individuals with thin or no traditional credit histories;
- Alternative scores can be generated for most individuals who lack traditional credit scores about whom lenders/providers would otherwise have very little information on which to base their credit decisions;
- Alternative scores provide a reasonable method of ordering risk among potential borrowers/customers, or ranking individuals according to level of risk;
- Those with thin or non-existent traditional credit histories may include prime borrowers/customers as well as those with higher credit risk than the general population⁵⁷.

Obtaining and using alternative credit scores may not be possible for all customers or providers. Having sufficient data to make judgments will depend in part on how readily available and viable the information is deemed to be. However, this approach offers one alternative which might help potential customers access services from which they are effectively excluded at present.

In the UK, perhaps the most promising development is being led by Big Issue Invest, a subsidiary of *The Big Issue*. Its Alternative Credit Rating project aims to learn from positive trends in the USA and test the business case for using alternative data on which to test credit worthiness where data is limited. Ultimately, the aim is to extend the number of customers who can gain access to affordable credit rather than turning to high-cost doorstep lenders through lack of choice. Measures to be explored include:

- Rental payments
- Utility payments
- Telecom payments
- Insurance premiums
- Retail payments including on-line and mail order catalogue
- Alternative sources of credit, including doorstep

The first stage of building an 'Alternative Credit Index' in the UK will involve analysing data on 250,000 tenants from social landlords to test its predictive value against standard credit scoring techniques.

If the use of mobile phones or other forms of technology grow, perhaps these could be added to alternative data sources enabling more low-income consumers to build their credit histories and enter the financial mainstream.

⁵⁷ The Predictive Value of Alternative Credit Scores, Centre for Financial Services Innovation Chicago, Illinois, November 2007.

7. Understanding low-income neighbourhoods through alternative data

It is becoming accepted that economic transactions of low-income consumers and some communities are under-reported in official statistics. A greater reliance on the cash economy together with mobile populations and intermittent or weak engagement with market providers makes it difficult for standard indicators to assess spending profiles and economic potential in the way that they may do for more established, affluent communities who engage more consistently with mainstream providers and whose actions can be measured more accurately.

Greater knowledge of low-income market niches should lead private sector providers to better understand consumer needs. Research by Business in the Community has suggested that *'in the USA, traditional market analysis using indicators such as household income has proved insufficient in forming strategies for serving low-income consumers. In the UK, market entry is still formed through these techniques, with ad hoc strategy formulation to allow for local differences. In North America, industry groups and research organisations have begun to look at buying power and expenditure measures of communities, to take account of both the hidden cash economy, and the concentration of households within communities'*.⁵⁸ This approach is also being used in under-served markets, where companies often need to collect new types of information in new ways in order to get an accurate and useful picture of consumer behaviour.⁵⁹

One study on behalf of the Greenlining Institute identified some of the difficulties in obtaining robust information.⁶⁰ In their view:

'Potential investors remain largely unconvinced of the economic viability of low-income neighbourhoods primarily because businesses do not have the relevant data available to them to make informed decisions. Low-income areas are particularly susceptible to information gaps for three main reasons:

- *A lack of day-to-day business transactions,*
- *The high cost of data, and*
- *Non-favourable perceptions.*

If transaction data is a principal factor in decision-making, those areas with fewest transactions (i.e. areas under-served by retail and service providers) will be, by definition, least understood.'

In the UK, Business in the Community's Under-served Markets project identified that traditional research into low-income neighbourhoods has been primarily based on indices of deprivation. Yet in order to engage successfully with the business community, the measurement objective is analysis of existing commercial opportunities rather than social problems.⁶¹

For example, one survey (2002) suggested that many retailers believed under-served markets did not have enough of their target consumers or adequate purchasing power. This

⁵⁸ Business investment in underserved markets – an opportunity for businesses and communities, Business in the Community on behalf of DTI. 2005

⁵⁹ *Untapped: Creating Value in Underserved Markets*, John Weiser, Michele Kahane, Steve Rochlin, and Jessica Landis, Centre for Corporate Citizenship, Boston College, Berrett-Koehler 2006 <http://www.untappedbook.com/index.html>

⁶⁰ *Hidden in plain sight: How different data yield vastly different understandings of the same market. A comparative analysis by asset vs. deficiency data*, Jamie Alderslade at Social Compact, Inc. Submitted to the Greenlining Institute December, 2005

⁶¹ *Underserved markets: Preliminary research findings*, Business in the Community, Office of the Deputy Prime Minister Neighbourhood Renewal Unit and Experian.

is often untrue. The reason behind this misunderstanding was the recognised lack of solid market data. Traditional analysis has proved inadequate. For low-income groups, reported income is often lower than it actually is due to the fact that the cash economy (a growing source of income) is not taken into account. Information supplied by local businesses coupled with new market indicators such as concentrated buying power and actual spending patterns can supply a more accurate picture.⁶²

In the first *Making Markets Work* report we identified the potential value of the Market Drilldown Model pioneered by Social Compact, an organisation dedicated to providing better market information on inner city communities in the United States. This is a market analysis model built on a range of business data sources to provide a more accurate picture of economic activity and purchasing power in under-served communities. It is designed to display to businesses the hidden strengths of under-served communities by providing an alternative analysis of population, income and housing which is more contemporary, detailed and accurate than censuses which only occur every ten years, and indices of multiple deprivation which highlight deficits rather than economic assets.⁶³

This approach is particularly useful in analysing complex and changing urban environments. In order to provide an insightful and nuanced conclusion, the Drilldown technique synthesizes various different data sources ranging from business to local and national government. These alternative data sets include: building permits, bill payment data, tax assessor data, school enrolment, reported crimes and property sales. The conclusions of this analysis are then cross-referenced against local knowledge and experience. An example is given below:

When Social Compact carried out a *Drilldown* on the Columbia Heights community in Washington D.C. they found that the economy and the population were growing faster than suggested by other sources, such as the Census. The population was just over 50 per cent higher and the rate of growth was 55.9 per cent higher than the U.S. Census reported. These two differences were largely a result of multiple families living in single households and the large number of immigrants into the market. The Drilldown also found a higher average annual household consumption than the Census (\$58,752 as opposed to \$43,606) – this increase due to the inclusion of the cash economy.

Drawing upon alternative data sources and local information to complement existing knowledge can thus provide a more reliable picture of neighbourhoods, leading to more accurate assessments of risk and potential. The Urban Markets Initiative⁶⁴ at the Brookings Institution has introduced Pathfinders which are demonstrating progress in capturing market potential by investing in communities. For example, the 2007 Urban Market Pathfinders comprises retailers, developers, city authorities and an investor who together have achieved *better performing retail stores and centres that better connect urban residents to retail services*. Moreover, their findings could apply beyond the retail sector. They concluded that:

- The lack of goods and retail services in some urban markets is due to imperfect information, not the absence of a viable market;
- Information gaps occur when information on human, economic and physical assets is not available, inaccurate, or unused;

⁶² Development in Underserved Retail Markets: a summary of the discussion of the challenges and recommendations for improving the process of retail development in underserved retail markets, International Council for Shopping Centers and Business for Social Responsibility, July, 2002

⁶³ Untapped: Creating Value in Underserved Markets, John Weiser, Michele Kahane, Steve Rochlin, and Jessica Landis, Centre for Corporate Citizenship, Boston College, Berrett-Koehler 2006 (p21) for more information see <http://www.socialcompact.org/pdfs/CincinnatiDrillDownReport.pdf>

⁶⁴ The Urban Markets Initiative aims to improve the quality of the information available on urban communities to unleash the full power of those markets to connect them to the economic mainstream.

- While better information and analytic tools can facilitate private sector investment decisions, the public and non profit sectors are useful partners to navigate the landscape to achieve retail success;
- The right data, methods and tools that capture true urban market purchasing potential need to be utilised more by the private sector;
- The corporate perspective on urban markets must be properly aligned with true market realities;
- Retail investment in urban areas, or the lack thereof, flows from corporate strategy. If that strategy cannot adjust to market realities, then all decisions will be ‘misaligned’;
- Appropriate access to goods and retail services is a key component in creating healthy communities.

Where market niches and opportunities are better understood, providers may become more interested in investigating alternative business approaches which can more effectively lever the purchasing power of low-income consumers and communities.

Emerging from a context marked by high levels of economic inequality and a poorer state safety-net, evidence from US cities points to innovative approaches to include low-income consumers and improve services in poorer neighbourhoods. In contrast, risk assessment methods appear to be some years off the pace in the UK and the drivers for serving low-income consumers more effectively appear to be weaker. Evidence from the interviews we conducted in various sectors pointed to a complacent view of market functioning, out-dated assumptions about risks and returns and a tendency to ‘over-report’ the benefits of voluntary actions taken to assist vulnerable consumers. With a few exceptions, we found a pattern of behaviour that owes more to minimal compliance than market innovation. One example from a food retail expert highlights the point:

“They (retailers) won’t do this because they don’t have to. They’re set up to work in another way. They might consider alternative indicators if they have to, but at the moment their traditional indicators suit them fine.” (Food retail analyst)

“Having to” act suggests major companies are prepared to wait and see if regulatory pressures are likely to require further action. Engaged in a race to compete for higher-income/lower-risk customers, sizeable market niches remain under-served. The failure is not that market solutions cannot be found to offer sustainable services to low-income consumers. There is enough evidence to demonstrate the contrary⁶⁵. Rather, it is the ‘beauty contest’ around corporate social responsibility initiatives that distracts from the failure to compete fully across the core business. CSR actions are often valuable but are never a substitute for fair and competitive practice for all consumer groups.

⁶⁵ Various case studies can be found in *Untapped: Creating Value in Underserved Markets*, John Weiser, Michele Kahane, Steve Rochlin, and Jessica Landis, Centre for Corporate Citizenship, Boston College, Berrett-Koehler 2006.

8. Alternative business models for under-served markets

In Section 5 we identified how technology offered alternative approaches to paying bills, and accessing and moving money that might appeal to low-income consumers. For businesses, exploiting developments in technology in both service delivery and processing transactions should be a high priority. However, careful thought has to be given to serving consumers previously excluded from particular services:

*“Overlaying a new technology solution on existing business processes, without first rethinking those procedures, can increase, rather than diminish, the cost and complexity of doing business. To be successful the business models and the underlying technology need to evolve together and be delivered in tandem”.*⁶⁶

*“Traditional ways of doing business will not work in serving this segment - new business models must emerge, leading to the development of firms that are neither banks, nor money service businesses, but something in between. It is important to understand these consumers’ past experiences and find ways to reach them through appropriate products and distribution channels”.*⁶⁷

Although aimed at the financial services sector, the ethos behind these quotes could apply to other service providers considering how to meet the needs of under-served consumers. The consistent finding appears to be the need to reassess business models and adapt mainstream products and services in order to succeed. Although focused on those living in absolute poverty in developing countries, some elements from the ‘Base of the Pyramid’ model can be applied to low-income markets in the OECD.⁶⁸ The model suggests businesses should:

Respond to specific needs: Firms should ensure they take into account local conditions and cultural norms, rather than repackaging a product or service that has been developed for another market. Sharia-proof bank accounts, mortgages and savings products for Muslim customers are such an example.

Adapt product and brand development timeframes: Both product development and building brands takes longer than in more developed markets, so it is essential to demonstrate to internal decision-makers in the company the business case for allocating appropriate time and resources.

Build trust: Companies often struggle to make low-income consumers feel like real and valued customers.

Engage non-traditional business partners: A critical role can be played by civil society organisations and NGOs that have direct knowledge of the economic or social need that a product or service is designed to address. These partners bring ‘social market intelligence’ as well as potential distribution channels.

Harness innovation: Companies need to think beyond the delivery of their products and services to market, to consider how these are used by low-income consumers. This ensures that appropriate linkages can be made with other service providers and partners.

Collaborate: There are also a number of opportunities for companies to work collectively across sectors to add value and help scale up existing initiatives, including:

⁶⁶ Janine Firpo, *Banking the Unbanked: Technology’s Role in Delivering Accessible Financial Services to the Poor*, SEMBA Consulting, 2005 www.fdc.org.au/Electronic%20Banking%20with%20the%20Poor/4%20Firpo.pdf

⁶⁷ Report of key findings from The Inaugural Underbanked Financial Services Forum Produced by The Center for Financial Services Innovation and Source Media, July 2006

http://www.sourcemediaconferences.com/CFS107/highlights_underbanked_forum.pdf

⁶⁸ C.K. Prahalad, *The Fortune at the Bottom of the Pyramid*, University of Michigan

- Exploring links between products/services and clustering efforts to serve low-income markets;
- Sharing information about supply and distribution networks, for example through the creation of supplier databases;
- Supporting supply and distribution networks for mutual benefit, for example by jointly sourcing products, developing standardised supplier training modules or aligning local procurement policies.

Households at this end of the market tend to offer significantly lower commercial returns for providers and in the push to serve the needs of higher-income/lower-risk consumers, it is probable that viable market niches have been neglected as they are considered economically marginal. The potential to develop lower-profit opportunities (as distinct from assumed loss-making ventures) may have been missed. Moreover, the likelihood of securing a higher degree of *customer loyalty* and possibility of 'migration' to other products at this end of market in response to good service may have been overlooked. While adapting the way businesses operate is neither easy nor quick, some providers are approaching saturation point in their existing competitive markets. We believe it is therefore time for companies in the UK to think in more sophisticated ways about risk assessment and business opportunities in under-served markets. The issue for many providers will not be about how to maximise profit from a price based model, but how to build diversified profit streams from new forms of transaction. Products and services need to respond to the spending power and preferences of under-served consumers and to reflect these in the goods and services offered.

9. Market-making and corporate responsibility

Eleven companies contributed to the development of *Marketplace Responsibility Principles* published by Business in the Community at the end of 2006. Among the Principles were:

- **Support vulnerable customers:** understand which of your customers may be unusually adversely affected by the product or service or by interruption of supply. Take steps to mitigate these effects.
- **Seek potential customers within excluded groups:** if appropriate, identify whether your product or service would provide real benefit for people that are currently excluded from it, whether through poverty, geography or disability.

Acting with responsibility in the marketplace – i.e. how a company goes about its core business – appears to provide a more effective focus for serving the needs of low-income consumers than the more common emphasis on ‘corporate social responsibility’, at least in the UK context.

We looked at the most recent Corporate Social Responsibility (CSR) reports of a selection of providers in the telecoms, energy and retail sectors to identify what references, if any, were made to disadvantaged consumers.⁶⁹ Overall we found some examples of companies aiming to ‘give something back’ to this market segment, though in some cases these involved ameliorating negative effects caused by their own business practices (e.g. premium charges on pre-payment meters). To better meet the needs of vulnerable consumers, many companies work with third sector organisations supporting disabled or older customers and those struggling to pay bills. Many have developed guidance for staff and more accessible product information for disabled customers. Examples from the energy sector include:

- Schemes with a range of charity partners providing free insulation and benefit health checks.
- Energy Trusts aimed at reducing fuel debt in partnership with Citizens Advice.
- Packages helping customers who are older, disabled or living with an illness.

Example of CSR action: Energy People Trust Fund (Scottish Power)

Scottish Power works with third sector organisations helping to identify people in need of grant support (covering energy efficiency; crisis funding; income maximisation; and research). A total of £3 million has been invested across 76 projects to date, assisting 55,000 households. The Trust Fund’s work on unclaimed benefits suggests that £20 is returned for every £1 invested – a significant factor given increased incomes account for fully half of the reduction in fuel poverty when prices are also falling.

Almost all the examples identified appear to be positive interventions on their own terms. By definition, these are voluntary actions often shading into charitable activity. We have not explored company motivations for CSR activity, but we might expect a mix of positive communications/publicity, philanthropy and perhaps tax efficiency. However, by being located as a distinct set of activities, the risk is that these distract attention from the core business. If it is the case that:

⁶⁹ We define Social Responsibility as people and organisations behaving ethically and with sensitivity toward social, cultural, economic and environmental issues. Striving for social responsibility helps individuals and organisations have a positive impact on their business and society while making a positive contribution to bottom-line results.

*'an important dimension of corporate citizenship is the way companies develop and align their products and services to create greater value for society as well as the company'*⁷⁰,

then principles of corporate responsibility ought to be evident throughout a company's activities rather than ear-marked for the CSR department. Indeed, our experience in various sectors (not least financial services) persuades us that CSR activity is often led by highly committed individuals who struggle to influence high-level decision making internally.

Porter and Kramer support the view that companies should integrate a social perspective into core business frameworks already used to understand competition and guide strategy. They believe that profit and social improvement can be achieved simultaneously, but this is most effective when corporate responsibility efforts concentrate on issues that are directly relevant to the company.⁷¹ They have defined 'strategic CSR' as:

'Going beyond best practice, doing things differently from competitors in a way that lowers costs and better serves a particular set of customers'.

If we take their concept of strategic CSR and apply it to products and services aimed at under-served consumers, there should be tangible outcomes for both parties. To do so:

- Businesses need to adapt their products and services to the market demand and product preferences of consumers;
- Such products and services may combine philanthropic and commercial aims, but need to be sustainable in the longer term.

In the UK, CSR has been more a flag of convenience than a driver of innovation in how companies act. We believe there should be more emphasis on 'market-making' where mainstream products and services better meet the needs of under-served consumers, rather than undue attention to 'good works' at the margins of the business. Unless companies see for themselves the business logic in serving low-income consumers and neighbourhoods more effectively, the risk is that all efforts to improve their experiences will be classed as regulatory. It is probable that corporate responsibility and core business goals will fail to converge. As one major retailer explained:

"We're in this, first and foremost to make a profit. We're a PLC, that's our job. If we can help support some local social needs, that's fine but we won't be driven by this. Nor will we be led by the public sector. We always have other options and will use these as a lever in decision-making. If it's not going to work for us in our way, we can always walk away and take the jobs and services we provide elsewhere. Politicians often pull their punches because of this." (Food retailer).

The provision of many essential goods and services is left mainly to market forces in the UK. Regulatory pressure is placed on providers through the Office of Fair Trading, the Competition Commission and various sectoral bodies like Ofgem, Ofcom and the Financial Services Authority (FSA). A Universal Service Obligation applies in a limited number of cases, ensuring that all households can access a fixed-line telephone and that, for now, it costs no more to post a letter from Stornoway to London than it does from Surrey⁷². However, it is fair to say that many providers do not appreciate the potential value of the market that low-income and disadvantaged consumers make up. The dynamics of under-served markets do not fit with traditional business models applied to mid and high income consumers. For example, payment and distribution channels need to be able to handle

⁷⁰ Boston College Centre for Corporate Citizenship – Corporate Citizenship Framework
http://www.bc.edu/centers/ccc/ce/newsletter/newsletter_may07.html

⁷¹ 'Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility' by Michael E. Porter and Mark R. Kramer (December 2006)

⁷² However, Royal Mail is known to be keen to explore 'zonal pricing' which would end the role of universal pricing. The consumer watchdog PostWatch opposes such moves.

smaller and more frequent transactions for people who prefer to pay up-front when they have the means to do so.

Economists are generally agreed that, when it is feasible, competition offers the best way to promote economic efficiency. Competition helps minimise costs by compelling businesses to innovate to reduce costs, to improve quality and expand product choice in their continuing bid to attract and retain consumers. In contrast the absence of competition reduces pressure on businesses to improve quality or reduce inefficiencies. However, in some market niches, neither competitive nor monopoly status applies. Under-served consumers, typically on a low-income and/or living in neighbourhoods considered too poor or remote to be attractive, tend to have access to a range of providers offering goods and services at a higher unit price and with conditions attached. Where measures are taken to assist those with particular financial difficulties, e.g. social tariffs, information tends to be patchy and delayed. Assistance is usually reactive, when debt problems have already occurred, rather than proactive.

Providers of everyday essentials like fuel, telecoms and food, can still do business profitably in under-served markets, even if profit margins are less than at the middle to high income end of the market. By doing more in these areas a wider customer base can be secured, potential new suppliers sourced and stronger neighbourhood ties forged. Competitive advantage and enhanced reputation can be found in under-served markets if businesses are prepared to adapt. A similar view is expressed by the International Business Leaders Forum (IBLF):

'By finding innovative ways to penetrate low-income markets and respond to their needs companies can unlock new business opportunities, and contribute to social and economic development'.

They go on to suggest that:

'Social entrepreneurs can help companies both design products and services that create value for low-income people and distribute those products and services more efficiently'.

The challenge to providers is clear: to seek new ways of assessing risk, pricing and doing business sustainably in order to grow their market share. Some may choose to compete mainly for higher income/lower risk consumers and it is their right as private companies to do so. However, notwithstanding the so-called 'credit crunch' associated with sub-prime mortgage lending, the emerging evidence from North America suggests that partnerships of business, third sector agencies and government are overcoming some of the traditional barriers to market functioning for under-served consumers using stored value cards, mobile technology, new approaches to measuring credit worthiness and neighbourhood spending power. It is possible that UK businesses will follow eventually. But it would be far more encouraging if key companies in each sector saw the long-term business case in adapting products, service and distribution channels to better serve today's low-income served consumers.

Footnotes

¹ In the UK, households are considered to be living in poverty if they have less than 60% of the median household income (where the median is the level of income after direct taxes and benefits, adjusted for household size). In Scotland, 18% of the population live in relative poverty before housing costs (880,000 individuals), rising to 20% after housing costs (990,000 individuals). Figures included in Scottish Government (2008) *Taking Forward the Government Economic Strategy: A Discussion Paper on Tackling Poverty, Inequality and Deprivation in Scotland*.

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