



**Consumer  
Focus**  
Campaigning for a fair deal

# Fuel price inflation and low income consumers

**William Baker**

# About Consumer Focus

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Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

## Background

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Independent research carried out by the Institute for Fiscal Studies for Consumer Focus shows that over the past decade low income consumers have experienced higher inflation rates for the typical 'basket of goods' they buy when compared with higher income consumers.

The above-inflation rise in fuel prices is a major cause of this – fuel expenditure accounts for over twice the total budgets of low income consumers than that of better off consumers. The research also provides worrying evidence that low income consumers are likely to respond to anticipated future fuel price rises by cutting back on essential fuel consumption, thus suffering cold homes as a result.

Consumer Focus believes the Government and fuel companies should make more effort to mitigate the impact of fuel price rises on low income consumers.

# Introduction

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Consumer Focus is very aware that the dramatic rise in fuel prices in recent years has hit energy consumers hard, particularly those on low incomes. We are also aware that the substantial increase in fuel poverty – from 1.2 million households in England in 2004 to a projected 4 million in 2010 – is largely due to increased fuel prices<sup>1</sup>. With rising prices predicted to continue, we wanted to explore in more detail how fuel price inflation has affected low income consumers. We therefore commissioned the Institute for Fiscal Studies (IFS) to carry out an in-depth, independent study of the spending patterns and inflation experience of low-income consumers over the past decade, particularly with respect to fuel and water. The research quantifies the impact of fuel and water price inflation on low income consumers, including different groups of low income consumers, and provides evidence of the likely impact of projected future fuel price rises.

This report summarises the findings of the IFS research and draws out some broad implications for policy. The policy perspective is that of Consumer Focus and does not reflect the views of the IFS. A full report of the research is available on the IFS website at: <http://bit.ly/irJb4b>

## Summary of the research findings

The IFS research analyses recent trends in household spending, with a focus on fuel and water. It examines the impact of changes in the price of these goods on household inflation, particularly for those on low incomes and those for whom state benefits make up the largest component of their income ('benefit-dependent' households).

The research found that there are clear differences in spending patterns between high- and low-income households. Low-income households tend to devote a greater share of their spending to fuel and water than higher-income households. In 2009, the poorest 10 per cent of households (ie the lowest 'income decile') spent on average over twice as much of their budget on fuel compared with the highest income decile (7.7 per cent and 3.4 per cent respectively).

In recent years, inflation rates have been particularly high for goods that make up a larger share of the budget of low-income households. In particular, domestic fuel prices rose very rapidly during 2006 and again in 2008: fuel price inflation reached a peak of almost 40 per cent in September 2008. Between January 1997 and December 2010, electricity prices rose by 67 per cent and gas prices increased by 139 per cent, compared with a rise of 48 per cent in the overall Retail Price Index (RPI) over the same period.

However, it is not the case that fuel prices have increased more rapidly than average prices in all years. In some years the opposite has been the case. In 2010, for example, average fuel prices fell over the year while the RPI rose above its 1997-2010 average.

On average, lower-income households had higher inflation rates over the last decade than higher-income households. In particular, the second-to-lowest income decile experienced the highest average inflation rate over the period 2000 to 2010, with a rate of 3.5 per cent. This contrasts with the highest income decile, who experienced the lowest inflation rate, at 2.9 per cent.

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<sup>1</sup> DECC (2010), *Annual report on fuel poverty statistics 2010*, DECC

The research also found there were differences in inflation rates *within* income groups. Within the lowest income quintile (ie the poorest 20 per cent of households), pensioner households experienced an average inflation rate of 3.8 per cent, compared with a rate of 2.8 per cent for those aged under 35.

Within the lowest income quintile, there were also differences in the average inflation rate experienced by different family types and by different housing tenure groups over the last decade. Single pensioners experienced the highest inflation rates in both the top and bottom quintiles. Within the lowest income quintile, those with mortgages experienced the lowest average inflation rates at 3.1 per cent, compared with 3.9 per cent for those who owned their homes outright.

Changes in the price of fuel and water make larger contributions to the overall inflation rates of low-income households than to those of higher-income households. For instance, in 2006 fuel price inflation averaged 24.6 per cent, and the effect was to increase average inflation rates of the lowest income quintile by 1.8 percentage points. This compares with a contribution of just 0.8 percentage points for the highest income quintile in that year.

The Department of Energy and Climate Change (DECC) predicts fuel prices will increase over and above general inflation in the medium term future. Other things being equal, these price rises will work to increase inflation rates of poorer households relative to richer households.

The research found that lower-income households reduce their consumption of fuel proportionally more than higher-income households when fuel prices increase. It estimated that the median household in the poorest quintile will reduce their fuel consumption by 6 per cent in response to a 10 rise in fuel prices. The median household's response in the highest income quintile is negligible: essentially holding its consumption constant.

Future price rises are therefore likely to result in higher income households increasing their spending more in absolute terms on fuel than lower income households, other things being equal. However, the research also suggests that lower-income households will heat their homes to a lesser extent and thus suffer cold homes as a result of price rises.

## Defining 'fuel poverty' and 'low income'

Consumer Focus considers the IFS research has important implications for fuel poverty policy. However, before outlining our proposals, we first discuss some definitional issues.

The IFS research looks at 'low income', rather than the 'fuel poverty' as such. The IFS uses an 'equivalised' definition of 'income' whereas the 'full' and 'basic' income definitions of fuel poverty used by the Government do not equalise incomes (equalisation adjusts the income assigned to a household to take account of the size and composition of that household)<sup>2</sup>.

The IFS also looks at actual household expenditure on fuel whereas the fuel poverty definition is based on 'required fuel expenditure'<sup>3</sup>. The latter is based on a technical evaluation of a dwelling and its heating system and assesses the energy required to bring a home up to an adequate temperature standard and meet other household energy needs. Thus, the fuel poverty definition takes account of the fact that many low income households significantly 'under-spend' on fuel (ration their fuel use) to keep their bills more manageable. This of course means many suffer cold homes as a result.

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<sup>2</sup> See Fahmy (2011), *Defining and measuring fuel poverty*, Consumer Focus for further discussion of equalisation and other aspects of the fuel poverty definition.

<sup>3</sup> See DECC (2010), *Fuel poverty methodology handbook*, DECC for more details of how fuel poverty is calculated.

Despite these differences, there is considerable overlap between low income and fuel poverty. For example, 80 per cent of the lowest income decile in England lived in fuel poverty on the full income definition in 2010; 86 per cent on the basic income definition<sup>4</sup>. The same research found that the lowest three income deciles accounted for 86 per cent of the fuel poor on the full income definition and 88 per cent on the basic income definition. Policies designed to ameliorate the impact of fuel price inflation on low income consumers are therefore likely to have a positive impact on fuel poverty.

## Up-rating benefits and tax credits

It is important to consider the extent to which the incomes of low income consumers have kept pace with fuel price inflation in the past and likely impact of fuel price inflation on their spending patterns in the future. Given that benefits and tax credits represent an important source of income for many low income households, the method by which they are up-rated has an important bearing on their ability to afford essential goods.

In some years RPI/CPI<sup>5</sup> is higher than fuel price inflation, for example 2010. Some therefore argue that households dependent on benefits will find it easier to pay for fuel in those years. In other years, the opposite is the case. The argument therefore follows that those reliant on benefits experience a 'swings and roundabouts' effect with respect to the annual up-rating of benefits and tax credits. Thus, there is no advantage to low income consumers in reforming the up-rating method, ie they will be 'better off' in some years and 'worse off' in others.

However, at the time of writing this report, Scottish Power had just announced it would increase gas prices by an average of 19 per cent and electricity prices by 10 per cent<sup>6</sup>. Many commentators expect other fuel companies to follow suit<sup>7</sup>. DECC has forecast fuel prices will rise at a rate faster than the anticipated rate of increase in inflation over the medium term (up to 2015), and this is before the impact of feed-in tariffs and carbon floor price support rates on prices<sup>8</sup>. This would suggest that the current method of up-rating benefits and tax credits will mean benefits and tax credit rates will not keep pace with the likely inflation rate for fuel for the next five years or so.

Consumer Focus is therefore very concerned that low income consumers will respond to future price rises by either spending a larger proportion of their budgets on fuel, requiring them to cut back on other essential items, or cut back on their consumption of fuel and therefore suffer cold homes (as suggested by the IFS research). We next consider the policy implications of the IFS findings

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<sup>4</sup> Preston, I et al (2010), *A 'now-cast' of fuel poverty in 2010*, Consumer Focus. The 'full' income definition of fuel poverty includes benefits received for housing costs in the calculation of income. The 'basic' income definition does not include these benefits as income.

<sup>5</sup> Benefits and tax credits are now up-rated according to the Consumer Price Index (CPI), rather than the former method of using the RPI or Rossi Index. See the main report for discussion of the implications of this change.

<sup>6</sup> Scottish Power (2011), *Scottish Power increases gas and electricity prices and launches the cheapest product currently available*, Scottish Power press release 7/6/11.

<sup>7</sup> The Bank of England's *May 2011 Inflation report*, for example, predicts domestic fuel prices will rise by between 10 and 15 per cent before March 2012.

<sup>8</sup> See <http://bit.ly/jzn2nB>

## Implications of fuel price inflation for fuel poverty policy

1. The above inflation rise in fuel prices predicted for the medium term will hit low income consumers particularly hard unless mitigating action is taken to protect them. Consumer Focus thinks the Government should put a strategy in place that sets out how integrated action to tackle the three main causes of fuel poverty (poor energy efficiency, low incomes and high fuel prices) will enable it to reach its statutory fuel poverty target (the elimination of fuel poverty by 2016). We consider a major programme to improve the energy efficiency standards of the homes of the fuel poor, as part of a package to improve all homes, will help protect the fuel poor against future price rises.
2. The up-rating of benefits and tax credits should give greater recognition to the actual spending patterns of low income households, rather than the average basket of goods bought by all consumers. The future method of up-rating of benefits and tax credits should take into account the anticipated above inflation rise in fuel prices.
3. It is important low income consumers have access to the cheapest deals in the competitive market given the high proportion of their budgets spent on fuel. Many low income consumers are currently not participating in the market, in part because suppliers are not providing products that meet their needs. Current competitive deals focus on those able to pay by direct debit and on-line, facilities which many low income consumers cannot take advantage of.
4. Fuel companies should recognise that a high proportion of low income consumers' budgets are already spent on fuel and take account of this in their design of policies to recover arrears, set tariffs etc.
5. Some future price rises will come about as a result of replacing Britain's decaying energy infrastructure while others will arise from Government policies to de-carbonise the economy. The Government can control the design of the latter and should therefore take every step possible to minimise their impact on low income consumers.



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### **Fuel price inflation and low income consumers**

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