



# **Framework for an impact assessment of Ofgem's RMR "evergreen" proposals**

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# Framework for an impact assessment of Ofgem's RMR "evergreen" proposals

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## Framework for an impact assessment of Ofgem’s RMR “evergreen” proposals

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# Executive Summary

## SCOPE OF WORK

Frontier Economics has been asked to undertake an independent impact assessment of one particular aspect of Ofgem's Retail Market Review (RMR) core domestic tariff proposal, namely the restriction on suppliers to offer a single standard evergreen tariff per payment method. Given the challenging timeframe for this work, this report sets out a framework for evaluation and describes some preliminary analysis that can help us to understand what assumptions need to hold for Ofgem's proposal to limit the number of evergreen tariffs to be preferred to specified alternatives. The alternatives we are using for the purposes of this report are the "airline options" and the "price comparison only" options.

Given this approach, the report also serves as a scoping study to inform a more robust and evidence-based piece of work that could feed into Ofgem's ongoing work programme.

## CONCLUSIONS

Ofgem's Impact Assessment (IA) does not provide a sufficiently robust evidential basis for adopting Ofgem's proposed approach. Moreover, there is a serious risk of adverse outcomes emerging from Ofgem's proposals, both in terms of the possible longer-term economic effects of the policy and the upheaval of compulsory product change as the policy is implemented. These downside risks are not present in the "price comparison only" counterfactual, but may be, to a more limited extent, in the "airline options" counterfactual.

Ofgem's proposals have two key elements: better price comparability, and greater tariff simplicity. Ofgem expects both of these to enhance engagement, increase switching and intensify competition amongst suppliers to the benefit of all customers. The first of these can be expected, *a priori*, to promote better and more informed engagement in the market. However, greater tariff simplicity is essentially achieved through restricting choice. This might not only be detrimental in its own right, but could also act as a limit to competition.

### *Impact on choice*

The proposal to restrict all evergreen products to one per payment type will have a number of effects on customer choice that Ofgem has not fully assessed.

- Customers are being forced to stop consuming products that they are currently using. There are many valued aspects of evergreen products (such as paperless billing, dual-fuel, etc.) that will now no longer be available to customers.

- As a consequence, the proposals impose an additional cost on choice. Under the current arrangements, the evergreen tariff choice imposes a one-off switching cost on customers until the customer chose again. The proposals would require the cost to be re-incurred at regular intervals if those customers wish to continue to avail themselves of product features that they value, and which are currently supplied under evergreen products, but which under Ofgem's proposals would now be defined as non-standard. As a result, these customers would be left worse off.
- These additional costs could mean some customers prefer to remain in the standard evergreen segment of the market, and actually become less engaged with the market.
- To implement the policy Ofgem would compel all current evergreen customers to switch to the standard evergreen tariff, which may create upheaval and resentment as many customers will be forced to move away from valued products.
- Finally, tariff simplification is unlikely to be the best way of educating customers about electricity use and the benefits of innovative tariffs in preparation to take advantage of the new tariffs that will be available with smart meters. This process of education will take time. It is difficult to see how it will be helped by a process of simplifying tariff structures in the short term. Instead this is only likely to make the future task more difficult as customers are less used to dealing with anything other than single rate tariffs.

### *Impact on competition*

The proposals will also have an impact on competitive outcomes in the market. On the one hand, as noted, tariff comparability can be expected to reduce switching costs. Tariff simplicity may also make it easier to compare tariffs, but carries with it significant risks.

As Ofgem has asserted, the increasing homogenisation of evergreen products under the proposals, combined with the regulation of the standing charge, would be likely to lead to a convergence of prices in that segment of the market. Consequently, despite the potential reduction in switching costs, the gains to switching in this segment would also fall. Moreover, if customers perceive the evergreen product as the safe, authorised, regulated product (which may indeed be how customers would tend to view it in the light of being compelled to purchase it in the first place), then customers may stick with this product and switching will not increase and may indeed decline relative to the status quo. If this is the case, fewer customers will switch within the evergreen segment, and fewer customers will switch into the fixed-term market, and both these effects can be expected to lead to evergreen tariffs converging on a higher price.

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Moreover, the less willing and able customers are to switch between the evergreen and fixed-term products, the higher the risk of a “two-tier” market developing, where prices in the two segments diverge. In our view, the risk of these serious outcomes developing has not been adequately evaluated.

Of course, it may be possible that evergreen product has the effect of creating the perception of a “safety net” rather than a “comfort blanket” which encourages customers both to switch for smaller gains and explore the complexities of the fixed-term market with greater confidence. If this is the case, then more switching can be expected, which could generate more competitive outcomes.

### *The counterfactuals*

The “price comparison” counterfactual eliminates the risk of the worst case outcome under Ofgem’s proposals since it does not restrict product choice in the evergreen market segment. Since we regard that risk to be highly significant, in our view this option should be given further considered assessment.

It is possible that this option may also reduce the prospects of achieving the best case outcome under Ofgem’s proposals. To assess whether this is likely it will be important to undertake further analysis of customers’ likely responses, which we discuss in more detail below and in section 3.4.

In many respects, the “airline options” model falls between the RMR core proposals and the price comparison only model in terms of its expected effects. It could mitigate much of the loss of customer welfare that could stem from reduced choice and, as a less extreme intervention, is likely to have less of an impact upon consumer engagement (for better or worse).

### *Further evidence is needed to inform the IA*

To understand the range of possible outcomes under Ofgem’s proposals and the counterfactuals, additional research would need to be undertaken on the extent to which customers of different types would be willing to switch between the fixed-term and evergreen segments of the market. This research would need to be more considerably more advanced than Ofgem has undertaken to date.

In order to evaluate the costs and benefits of restrictions on products and tariffs in the evergreen market, customers in a survey would need to respond to a number of plausible situations that they could face if Ofgem’s proposals were implemented, so that prospective behaviour could be properly analysed under a range of scenarios. The key questions that such research should focus on include the following:

- What is the cost to customers of forcibly removing them from the tariffs they are presently on to the standard evergreen products, plus the costs of regular switching decisions that are needed to replicate what they presently

consume, and would those costs lead them to become disengaged from the market?

- What is the likelihood that customers become so used to simplicity that they cannot evaluate time of use tariffs when they are introduced, to such an extent that a central plank of government policy is not realised?
- What will be the switching behaviour of customers if prices converge in the evergreen market segment, as Ofgem asserts that they will? Will customers remain engaged and switch for much smaller gains, or would they become even less engaged??
- Will customers view the evergreen tariff as a safety net that gives them confidence to explore the fixed-term market? Or would they perceive it as a regulatory comfort blanket and stop engaging with the fixed-term segment of the market?
- What are the impacts on entry and expansion by new entrants and smaller players?
- To what extent can other counterfactual options promote greater engagement and switching with less downside risk?
- Given the answers to these key questions, what is the range of possible competitive outcomes that could arise if the proposals or other counterfactual options are considered?

In addition to these questions, a full impact assessment of the proposals would also need to consider the additional costs which may be imposed upon suppliers (and hence customers). We have identified that non-trivial one-off and ongoing costs may exist, although further work is required in this area.

### *The risks of regulatory creep*

As noted, our view is that there is a serious risk of adverse outcomes emerging from Ofgem's core proposals. In its draft IA, Ofgem does not quite admit the possibility of these types of outcomes, but does go on to say that if undesirable outcomes emerge, then it leaves itself open the option to apply further regulation:

*“The development of a two tier market would be an undesirable outcome, but may be no worse than the status quo in which sticky customers continue to pay more than non-sticky customers. In any case, the emergence of a two-tier market would be immediately apparent as we would continually monitor prices. We would take action to address any concerns relating to the*

## Executive Summary



*possibility of co-ordinated effects and any other unintended consequences arising from the tariff simplification remedies”<sup>1</sup>*

This line of reasoning is troubling for two reasons. First, it is placing significant reliance on some rather limited evidence and selected theoretical propositions to assert that its proposals may lead to outcomes that are no worse than at present. This faith in its own IA, despite its many omissions, is suggestive of some of the types of biases and irrationality that behavioural economics theory predicts that regulators can be prone to suffer from, which can lead them to make ill-informed decisions that do not promote economic efficiency<sup>2</sup>. The two biases that have been identified that are particularly relevant in this case are “optimism bias” that causes regulators to under-estimate the probability of a bad outcome; and “confirmation bias” which arises when regulators become wedded to a policy or proposal to the extent that contrary evidence is ignored or downplayed.

The second troubling aspect of this paragraph is that Ofgem appears to permit itself the option to re-intervene in the market and moreover gives itself considerable latitude to do so (in response to “any unintended consequences”). This catch-all clause is worrying for three reasons:

- ▣ it potentially renders Ofgem’s IA meaningless because it implies that if this policy package doesn’t work, then Ofgem will find another policy or intervention that will;
- ▣ it suggests that the further remedies that Ofgem has in mind are the re-regulation of the sector rather than a set of policies that will make competition work; and
- ▣ it implies that Ofgem has assumed that the present proposals and all the (as yet undefined) future policies to put regulatory sticking plaster over the unintended consequences of the previous policy initiative will yield a better outcome over the long term than any other alternative approach that could be implemented at this point in time.

Before Ofgem embarks on a policy route that carries a high risk of evolving into re-regulation of the sector, it would be prudent to evaluate remedies that avoid the downside risk associated with the present proposals, and which are pro-competitive in intent, and potential effect.

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<sup>1</sup> IA para 1.168

<sup>2</sup> Behavioural economics: implications for regulatory behaviour, by James Cooper and William Kovacic, *Journal of Regulatory Economics*, 2012, 41:41-58



# 1 Introduction

Frontier Economics has been asked to undertake an independent impact assessment of one particular aspect of Ofgem's Retail Market Review (RMR) core domestic tariff proposal, namely the restriction on suppliers to offer a single standard evergreen tariff per payment method. Given the challenging timeframe for this work, this report sets out a framework for evaluation and describes some preliminary analysis that can help us to understand what assumptions need to hold for Ofgem's proposal to limit the number of evergreen tariffs to be preferred to specified alternatives. The alternatives we are using for the purposes of this report are the "airline options" and the "price comparison only" options.

Given this approach, the report also serves as a scoping study to inform a more robust and evidence-based piece of work that could feed into Ofgem's ongoing work programme.

The report is structured as follows.

- We provide an overview of the proposed changes set out within the RMR, and our understanding of the benefits that Ofgem believe them to bring, in section 2. We also provide a description of the counterfactuals we will be comparing the core proposals against.
- In section 1 we consider the direct effect of the restrictions that would be imposed on evergreen products as a consequence of the RMR core proposals compared to the counterfactuals, and assess the potential impact on competition both within and across the evergreen and fixed-term segments of the market.
- Section 4 presents some preliminary estimates from suppliers of the additional costs involved in implementing the RMR proposals and the counterfactuals, and acknowledges the regulatory costs incurred by Ofgem.



## 2 Overview of the Ofgem proposals and counterfactuals

### 2.1 Summary of the proposals

Ofgem's RMR domestic proposals cover a wide range of changes to the energy supply market. These proposals fall into three areas: restrictions on evergreen tariffs; restrictions on fixed-term tariffs; and measures to improve consumer information.

#### 2.1.1 Restrictions on evergreen tariffs

A significant effect of Ofgem's proposals would be to limit suppliers to a single "standard" evergreen tariff per payment method and fuel.<sup>3</sup> This would also be the tariff which fixed-term customers would be placed on by default at the end of their contract (if they do not sign up to a further fixed-term contract).

The price structure of this standard tariff would be restricted to:

- a compulsory standing charge,<sup>4</sup> set by Ofgem; and
- a single (no tiers) unit charge<sup>5</sup> (Economy 7 customers will still face different day and night rates) set by the supplier.

In addition, suppliers would be prevented from offering discounts and combining standard tariff supply contracts with other goods and services.

#### 2.1.2 Restrictions on fixed-term tariffs

Ofgem's proposals for fixed-term tariffs contain a number of restrictions regarding switching windows, and a prohibition on unilateral price increases or other adverse unilateral variations for customers on these tariffs.

Additionally, customers at the end of a fixed-term contract would, by default, be placed onto their supplier's standard evergreen tariff, if they do not sign up to a further fixed-term contract.

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<sup>3</sup> There would be an alternative evergreen tariff for electricity customers with Economy 7 meters, and derogations available for Economy Ten and dynamic teleswitching tariffs.

<sup>4</sup> In Ofgem's December 2011 consultation, it was indicated that the standing charge would be set on a regional basis, to account for variations in transmission and distribution (T&D) network charges. However, a further consultation document released on 6 February 2012 suggests that, since Ofgem now consider that T&D charges could be recouped through the unit charge, the standing charge would be set nationally.

<sup>5</sup> If T&D charges are included in the unit charge, this will need to vary regionally. In the 6 February consultation, Ofgem outlined two options for this: either suppliers set a national unit rate and Ofgem sets regional adjusters; or suppliers set a regional unit charge that reflects cost differences.

### 2.1.3 Information remedies

Some of Ofgem's proposals seek to directly increase the information available for customers deciding whether to switch supplier. This could be implemented by requiring all suppliers to provide a standardised "Tariff Information Label" for all tariffs (both evergreen and fixed-term). This would include a price comparison measure (such as pounds per kWh and monthly costs for average consumption bands, on a "standard tariff equivalent" rate basis).

### 2.1.4 Summary

These proposals are summarised in the table below.

**Table 1.** RMR core proposal

<b>Number of allowable evergreen tariffs</b>	One tariff per payment method and per fuel (Economy 7 customers will have a separate set of tariffs, limited in the same way)
<b>Standing charge for evergreen tariffs</b>	A compulsory standing charge set by Ofgem
<b>Unit charge for evergreen tariffs</b>	A single (regional) unit rate (day/night rates for Economy 7 tariffs) <sup>6</sup> set by suppliers – no tiered tariffs
<b>Limitations on non-evergreen (fixed) tariffs</b>	Clear end date and switching windows. No auto-rollover (customers placed on to standard evergreen tariff unless they expressly say otherwise). No unilateral price increases or other adverse unilateral variations.
<b>Price comparison information</b>	Price information for fixed tariffs presented in a "standard equivalent" format. All tariffs provided with a "Tariff Information Label" providing key information.

Source: Frontier Economics

## 2.2 Ofgem's theory of benefit associated with its proposals

In its Draft Impact Assessment (IA)<sup>7</sup>, Ofgem summarises the benefits that it expects these proposals to deliver as follows.

<sup>6</sup> Or, where permitted under the derogation, applicable time-of-use tariffs for E10 and DTS customers.

## Overview of the Ofgem proposals and counterfactuals

*“The key objective of our tariff proposals is to enhance effective engagement by consumers. This can be achieved by improving tariff comparability, simplifying the structure of standard energy tariffs and improving decision making by customers. We also want our proposals to retain choice for customers and allow innovation, especially as smart meters are rolled out”<sup>8</sup>.*

Although this quote suggests Ofgem believes that greater engagement is an end in itself, Ofgem later argues<sup>9</sup> that the lack of engagement is resulting in a large number of sticky customers. Ofgem has said that the proposals represent its *“attempt to enhance competition in the retail energy markets and make it work more effectively so that the benefits can be realised by more consumers than at present”*.<sup>10</sup> We therefore assume that Ofgem is of the view that low levels of switching are often associated with less intense competition and consequential adverse effects for disengaged customers in particular (relative to the more engaged customers).

Ofgem’s first theory of benefit associated with its proposals can therefore be characterised as promoting comparability and simplicity to achieve greater customer engagement, making switching more likely and leading to increased competitive pressure. This process will result in customers becoming better off than under the status quo.

Ofgem also advances a second theory of benefit associated with its proposals which asserts that the standardisation of evergreen tariffs would lead to greater competitive pressure upon suppliers:

*“...standard tariffs would become increasingly similar as a result of our proposals. This may lead to suppliers competing on price rather than product differentiation in the standard segment of the market and, assuming suppliers do not collude or coordinate, this would put competitive pressure on prices to the benefit of the consumer. In accordance with standard game theory models, the more homogenous the products, the more intense this form of competition.”<sup>11</sup>*

Figure 1 below summarises these two theories of benefit, and the two main instruments it sees as delivering those benefits:

- through promoting comparability between tariffs; and
- by simplifying the choice of tariffs available to customers.

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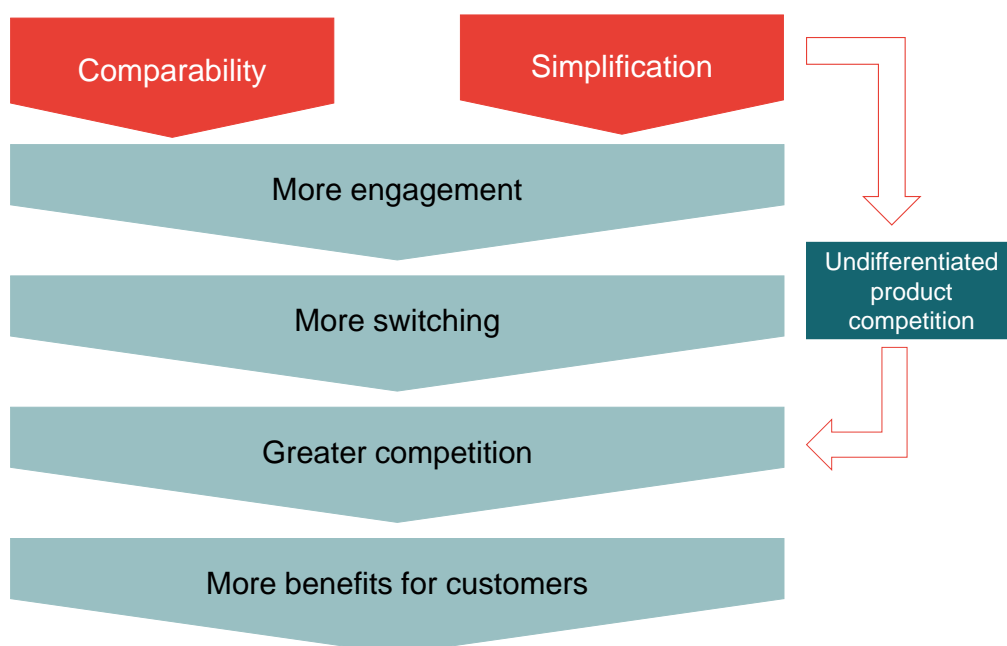
<sup>7</sup> The Retail Market Review: Draft Impact Assessment for Domestic Proposals, Ofgem, 1<sup>st</sup> December 2011

<sup>8</sup> RMR IA para 1.1

<sup>9</sup> RMR IA para 1.11

<sup>10</sup> “Context”, RMR

<sup>11</sup> RMR IA para 1.158

**Figure 1.** Our interpretation of Ofgem's theory of benefit associated with its proposals

Source: Frontier Economics

These are two distinct mechanisms, and many aspects of Ofgem's proposals will only act through one of these channels. For example, the standardised "tariff information label" could help comparisons between tariffs, but would not affect the overall choice available. Similarly, restricting suppliers to a single evergreen tariff per payment method may improve comparability across evergreen tariffs but if the same features that are currently included in evergreen products simply transfer to fixed-term products then this measure would not (in itself) aid comparisons between tariffs.

In our view, Ofgem tends to assert the benefits of the entire bundle of measures as a whole (other than in respect of its point relating to undifferentiated competition). However, for the purposes of an impact assessment, it is necessary to consider the impact of each policy measure on its own and in combination with other measures.

In the sections that follow, we will establish the framework, and the required evidence base, that is necessary to undertake a full impact assessment. It will be clear that more evidence would be required to evaluate whether Ofgem's proposals could be expected to have a positive net benefit.

## Overview of the Ofgem proposals and counterfactuals



## 2.3 Ofgem's theory of cost associated with its proposals

Ofgem's theory of cost, as outlined in paragraphs 1.172, 1.193 and 1.201 of its IA suggests that the primary costs of the policy proposals will be borne by suppliers in the form of one-off implementation costs and ongoing costs. In addition, we can expect some of these costs to vary depending on the proportion of customers that switch. Ofgem has not estimated these costs, but appears to consider that they are sufficiently low so as not to affect its conclusion that the proposals will have a net benefit. It does however indicate that it would welcome evidence from the suppliers on this point.

As well as the direct supplier costs, there will also be costs of regulation that will need to be estimated.

In the time available to compile this report it has not been possible to gather cost data from all the suppliers for the purposes of providing a robust indicative figure that could be used for the purposes of informing an impact assessment. However, we have gathered some data that give an initial and preliminary indication of the likely incremental costs associated with the proposals and counterfactuals which we report in section 4. As part of a fully quantified impact assessment, Ofgem would need to carry out further research into these costs (and the incremental regulatory costs) to demonstrate that they do not outweigh any benefits from the proposals.

## 2.4 Overview of counterfactual proposals

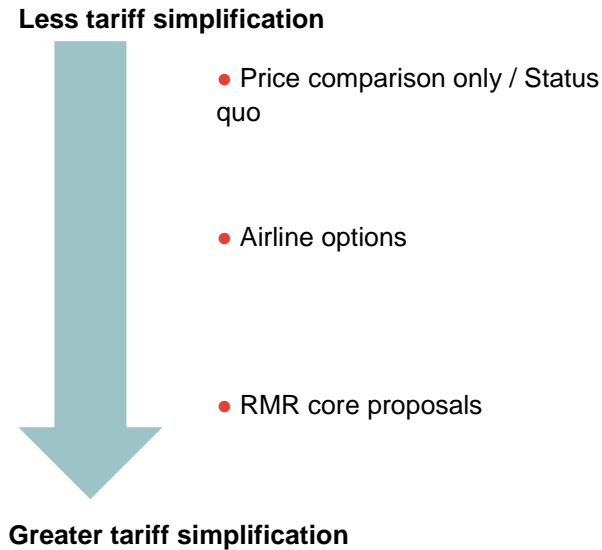
As well as providing an assessment of Ofgem's Draft IA in respect of the core domestic tariff proposals, we have also been asked to assess two counterfactual proposals.

The "airline options" approach that we define for the purposes of this analysis is similar to Ofgem's core proposals, but would permit suppliers to offer a range of optional extras with their standard evergreen tariff, in the manner of booking an airline ticket online. For example, suppliers might offer a "green" option (higher unit costs in exchange for a higher proportion of electricity being purchased from renewable sources), or a "paperless billing" option (with correspondingly lower unit costs). We summarise this counterfactual in Table 2.

The "price comparison only" approach represents a less extensive set of reforms. Under this counterfactual, the same range of energy tariffs would be available as today. However, suppliers would be required to present a price comparison guide alongside their tariffs. This counterfactual is summarised in Table 3.

Both counterfactuals and Ofgem's core proposal offer greater tariff comparability than the status quo. However, as shown in Figure 2, they vary considerably in the extent to which the choice of tariffs is simplified.

**Figure 2.** Comparison of the three approaches



Source: Frontier Economics

**Table 2.** Airline options

<b>Number of allowable evergreen tariffs</b>	As the RMR core proposal, but suppliers can present a range of “add-on” options that customers can select (similar to purchasing an airline ticket). For the purposes of the data collection exercise in section 4, we asked suppliers to consider a situation where they offer a choice of three options: online billing, dual fuel, and a “green” premium. Customers would be able to select any combination of these options.
<b>Standing charge for evergreen tariffs</b>	<i>As RMR core proposal</i>
<b>Unit charge for evergreen tariffs</b>	A single unit rate (day/night rates for Economy 7 tariffs) <sup>12</sup> set by suppliers, that will vary depending upon the options chosen by each customer
<b>Limitations on non-evergreen (fixed) tariffs</b>	<i>As RMR core proposal</i>
<b>Price comparison information</b>	<i>As RMR core proposal</i>

Source: Frontier Economics

**Table 3.** Price comparison only

<b>Number of allowable evergreen tariffs</b>	No restrictions (as today)
<b>Standing charge for evergreen tariffs</b>	No restrictions (as today)
<b>Unit charge for evergreen tariffs</b>	No restrictions (as today)
<b>Limitations on non-evergreen (fixed) tariffs</b>	No restrictions (as today)
<b>Price comparison information</b>	<i>As RMR core proposal</i> – suppliers would be required to present a price comparison guide with their tariffs (in a format designed by Ofgem).

Source: Frontier Economics

<sup>12</sup> Or, where permitted under the derogation, applicable time-of-use tariffs for E10 and DTS customers.



### 3 The effect of the RMR evergreen proposals on competition and consumer choice

As discussed in the previous section, Ofgem's tariff proposals are centred on an intention to enhance customer engagement as a way of promoting competition and allowing more customers to benefit from competition.

One route to achieving this is through greater transparency of tariffs to promote comparability (indeed, this is the only change made under the "price comparison only" counterfactual). This is a key element of Ofgem's core proposals and can be expected, *a priori*, to promote better and more informed engagement in the market.

The other route to achieving this objective is by imposing greater tariff simplicity. However, greater tariff simplicity is essentially achieved through restricting choice. This might not only be detrimental in its own right, but could also act as a limit to competition. Consequently, much of this section is focused on an assessment of the proposal to simplify tariffs, since this is the issue on which the IA will largely turn. This section is structured as follows.

- First, we assess the impact on customer choice of the restrictions in the evergreen market segment.
- Second, we consider the competitive effects of Ofgem's proposals.
- Third, we briefly consider the extent to which the counterfactual cases are affected by the key factors that will drive the choice and competition outcomes.
- Finally, we set out the key headline questions for Ofgem to consider in coming to its final conclusions on its RMR proposals that we do not feel have been sufficiently addressed in its draft IA.

#### 3.1 The effect on consumer choice of Ofgem's proposals

In this section we discuss:

- the effects of a reduced choice of tariffs in the evergreen tariff segment;
- the impact of the regulated standing charge; and
- the impact of take-up of time-of-use tariffs as smart meters are rolled out.

**The effect of the RMR evergreen proposals on competition and consumer choice**

### 3.1.1 The effect of a restriction in tariff types on consumer choice

Many customers currently benefit from the diversity of evergreen tariffs available. Customers with specific preferences (e.g. for renewable energy) are able to obtain a corresponding evergreen tariff. Additionally, customers that act in a way which reduces supplier costs (e.g. through the use of paperless billing) are able to share the benefits through lower bills that reflect avoided costs.

By reducing the number of options available to customers, Ofgem's core proposals will inevitably mean that many customers are unable to find an evergreen tariff which matches their needs and preferences.

Ofgem acknowledges this point, but states that "*The removal of these features [such as online and dual fuel discounts] from standard tariffs may be disliked by some customers and may mean that the new standard tariff structure would not appeal to them. However, we would expect a wide range of tariffs to be available in the non-standard segment of the market.*"<sup>13</sup>

However, this argument assumes that customers do not value evergreen products and/or do not see fixed-term products as having different characteristics that matter to them. In practice, there are reasons to believe that many customers do value evergreen products over fixed-term products; about 75% of customers have currently chosen evergreen tariffs.<sup>14</sup> Because fixed-term products cannot contain unilateral contract variation terms, prices must be fixed or linked to a recognised index. Given the difficulty of finding an index that both adequately reflects the risk to the supplier from price variation within the contract period and that could be understood by the customer, the majority of such products will be fixed price. To cover the risk associated with offering fixed price contracts, exit penalties are put in place. This makes them seem like very different products to a number of customers.

Some customers will also not like the idea of a contract that requires them to take regular action, given that such action takes a degree of effort on their part. If they have a choice between a product that they have to change once a year, with one where they can stay on it until they choose otherwise, they may (quite rationally) favour the later.

Consequently, whilst it is true that such customers may still be able to switch to fixed-term products that offer equivalent options, the fact that such customers have currently chosen evergreen products over fixed-term products suggests that such products may be less attractive to these customers.<sup>15</sup> Consider a customer

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<sup>13</sup> RMR IA para 1.77

<sup>14</sup> Littlechild (2012), *Ofgem's Procrustean Bed: a response to Ofgem's Consultation on its Retail Market Domestic Proposals*

<sup>15</sup> We note that this is unlikely to be due to customer disengagement, since customers on such tariffs have explicitly rejected their supplier's "standard" tariff.

currently on an evergreen tariff with additional features (such as the ability to earn Nectar points). Under the RMR core proposals, if the customer wished to retain a similar tariff, they would be required to:

- carry out the initial paperwork required to move on to the equivalent fixed-term tariff; and
- repeat this every time the contract comes up for renewal.

The time and inconvenience spent undertaking these tasks will have an associated monetary cost that would be borne by actively engaged customers. The proposals therefore impose an additional cost on choice – previously the evergreen tariff choice imposed a one-off switching cost on customers until the customer chose again, whilst the proposals now require the cost to be re-incurred at regular intervals if those customers wish to continue to avail themselves of product features that they value, and which are currently supplied under evergreen products, but which under Ofgem’s proposals would now be defined as non-standard. As a result, these customers would be left worse off. For some, the additional cost imposed could leave the customer better off by remaining in the standard evergreen segment of the market, and actually becoming less engaged with the market.

Further, the reason that Ofgem has offered for removing valued aspects of currently available evergreen products (such as dual-fuel options) is unpersuasive, but it does shine a light on Ofgem’s thinking. As Ofgem acknowledges, removing this product from the evergreen product range “*carries a risk of frustrating a significant number of customers. Our qualitative consumer research found that people did not see a benefit from withdrawing the dual fuel option and this could create a backlash from people who could blame Ofgem for an increase in their bills.*”<sup>16</sup> Yet Ofgem seems prepared to take this risk because “*dual-fuel tariffs obscure the margin difference between legacy and non-legacy fuels and so remove a consumer’s ability to tell whether their supplier is offering both the cheapest electricity and cheapest gas in the market....Our own analysis... has shown that consumers on dual-fuel direct debit customers could save up to £60 by switching to the lowest price supplier for both tariffs*”<sup>17</sup>.

There are two points worth making in respect of this argument. First, it implies that the relative prices that we observe under the present market arrangements will be the same ones to prevail under the new ones. As we discuss in more detail in section 3.2, the change in rules could change market outcomes considerably, particularly in respect of prices and terms that are offered across the evergreen and fixed-term market segments. Ofgem appears to be assuming that the single-fuel evergreen tariff that a supplier would charge post-RMR will be the same as

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<sup>16</sup> RMR IA para 1.243

<sup>17</sup> RMR IA para 1.280

the cheapest single-fuel tariff that it presently offers – there is no guarantee (or even expectation) that this will be the case.

Second, for customers to avail themselves of the cheapest dual-fuel tariff or single-fuel tariff they will need to be active customers. In order for these customers to be better off, Ofgem is making a strong assumption, unsupported by evidence, that these customers will respond positively to its measures and that they will induce more engagement. This will need to be sufficient to outweigh the likely damage to engagement that will result from customers finding they are being forced to move from products they have actively chosen. Further, they may find that the product they are being moved to has a more expensive rate (to reflect the costs associated with offering a fixed-term contract) while also being required to face ongoing costs of repeated switching to replicate the evergreen dual-fuel product that they presently enjoy.

In order to quantify these losses to consumer welfare, it would be necessary to carry out further research into how customers value the various options available to them at present, and how they would behave once Ofgem's proposals have been implemented. The survey evidence reported by Ofgem does not test how customers will react to being forced to move from their current products, and it is worth noting that the Competition Appeals Tribunal (CAT) remitted the point-of-sale remedy<sup>18</sup> in the PPI case as the Competition Commission (CC) had not provided sufficient evidence on how consumers would respond to it and whether its benefits would outweigh the loss of convenience. The CC therefore had to undertake further consumer research, including a number of experiments, before it could conclude that the benefit of the point-of-sale prohibition remedy would be expected to outweigh the cost of loss of convenience to customers.

### 3.1.2 The effect of regulation of the evergreen standing charge on customer choice

A special case of this general point is Ofgem's proposal to set the standing charge for all evergreen products. The restriction on choice that this will result in is an important one that Ofgem has not fully addressed in its draft IA. Customers with different characteristics are already on, or may want in future, a range of tariff structures including those with a low (or zero) standing charge with a higher unit charge, to those with a high standing charge and a lower unit rate. Others may have chosen rising or falling block tariffs. Following Ofgem's proposal, as with the other product options that now fall out of the evergreen market segment, customers will have to re-contract at regular intervals to replicate the products that they already consume.

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<sup>18</sup> Where a PPI (payment protection insurance) product would not be allowed to be sold at the same time that the product was purchased



There will be further implications of Ofgem's proposal to set a single regulated standing charge. A number of these stem from the fact that Ofgem is likely to be unable to set the standing charge at the "correct" level, even if it has good intentions to do so. This is because different suppliers will have different cost structures and therefore there is no "correct" level of charge. It is also because Ofgem wishes to hold the level of standing charge constant for long periods when the fixed costs of supply are likely to change. If the pricing structure imposed on suppliers does not reflect the costs that they face, this will introduce cross-subsidies between customers of different size and it will distort competition. For example, if the standing charge is set too low, every supplier will lose money on low use customers and make profit on high use customers. This will create an artificial incentive for suppliers to target profitable large customers at the expense of small customers.

### 3.1.3 The effect of a restriction in tariff types on take-up of Time of Use tariffs

As Ofgem notes, time of use (ToU) tariffs are expected to become increasingly important as a way for customers to manage their consumption following the roll-out of smart meters.<sup>19</sup> Indeed, the smart metering business case is based on an additional 20% of customers taking up ToU tariffs<sup>20</sup>.

Ofgem's logic for simplifying the structure of tariffs now, despite the fact that they can be expected to become increasingly complex in future, appears to be that it believes that its proposals will increase trust, engagement and competition leading up to the roll out of smart meters. This will mean that by the time these innovations (and associated complexity) become widespread, customers will be better disposed to take up those new tariffs.

Clearly, this logic depends on assuming that its proposals do have a positive impact on engagement and Ofgem does not consider the impact on the smart meter roll-out if this does not prove to be the case. If engagement is not improved then the benefits associated with innovative ToU tariffs will be slower to materialise. Further, now would seem to be the time to begin educating customers about electricity use and the benefits of innovative tariffs in preparation to take advantage of the new tariffs that will be available with smart meters. This process of education will take time. It is difficult to see how it will be helped by a process of simplifying tariff structures in the short term. Instead this is only likely to make the future task more difficult as customers are less used to dealing with anything other than single rate tariffs.

In the short term the proposals also have the unfortunate effect of allowing the benefits of ToU tariffs associated with the early roll-out of smart meters to

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<sup>19</sup> RMR IA para 1.238

<sup>20</sup> "Smart meter roll-out for the domestic sector – Impact Assessment", DECC (18 August 2011) p65.

accrue solely to active switchers in the fixed-term market, rather than available for all customers.

In summary, it does not appear that Ofgem has appropriately assessed the risks of its policy on how customers will become educated to allow them to fully benefit from the smart meter roll-out.

## 3.2 Competitive effects of Ofgem's proposals

In this section we discuss the potential competitive effects of Ofgem's core proposals, and the key assumptions that would need to be satisfied for the proposals to deliver ongoing benefits. This section is organised as follows.

- we first consider whether Ofgem's proposals are likely to encourage entry and expansion by new entrants and small suppliers;
- we then consider the effects of a reduction in diversity of products and tariffs in the evergreen sub-segment and whether it would to more engagement and switching in that market segment and also in the fixed-term segment of the market; and
- finally we summarise the effect of different levels of switching within and across market segments on competitive outcomes and benefits for customers.

### 3.2.1 Effect of the proposals on entry and expansion in the retail market

In our view, a useful test of Ofgem's proposals and the counterfactuals is the extent to which they can be expected to reduce barriers to entry and expansion in the retail market. Frontier has previously concluded that there are four barriers to entry in the retail market.<sup>21</sup>

- The increased scale of Government policy and regulatory intervention that suppliers are required to deliver that would be onerous for smaller suppliers wishing to expand their market share.
- Lack of liquidity, particularly that which smaller suppliers require to offer tailored "shaped" products of a small clip size that match their retail portfolio.
- The requirements for collateral to cover credit risk that present a barrier for smaller, less well capitalised players that do not have a credit rating.

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<sup>21</sup> *Competition and entry in the GB electricity market*. A report for Energy UK, Frontier Economics, December 2010

- Lack of stability in network charges which has increased the variability of network charges, and which lack transparency to suppliers about the direction and timing of changes to them.

It is entirely possible that Ofgem and other stakeholders could have a different view on the barriers to entry that currently prevail, but the same methodology would apply, which is that having identified them, it would be important to properly evaluate whether they are raised or lowered by the prospective policy measures. Based on the barriers listed above, our preliminary view is that the proposals will make little difference to the first of these barriers, but could have the effect of raising barriers to entry in respect of the second and fourth (and therefore the third) of these. If suppliers try to compete with the established six suppliers in the evergreen market, then they are particularly exposed to fixed cost volatility, since cost changes would be likely to occur before Ofgem re-sets the standard charge. This would require the smaller suppliers to carry more working capital or collateral to accommodate this risk. If smaller suppliers try to compete with the major suppliers in the fixed-term market, then it is likely that market liquidity would have to be increased significantly in order to enable these suppliers to offer competitive terms.

In addition, Ofgem is erecting a new barrier to entry through prohibiting entry into the evergreen market segment for innovative products offered by small suppliers and new entrants. New entrants would be forbidden from offering discounts on evergreen tariffs, or bundling an evergreen tariff with products they may already sell (such as other utility services).

### 3.2.2 Effect of a reduction in diversity of products and tariffs in the evergreen sub-segment

Ofgem asserts that the standardisation of evergreen products and tariffs would lead to greater competitive pressure on suppliers:

*“...standard tariffs would become increasingly similar as a result of our proposals. This may lead to suppliers competing on price rather than product differentiation in the standard segment of the market and, assuming suppliers do not collude or coordinate, this would put competitive pressure on prices to the benefit of the consumer. In accordance with standard game theory models, the more homogenous the products, the more intense this form of competition.”<sup>22</sup>*

This assertion is consistent with a model of Bertrand (price) competition between firms that differentiate themselves along one or more dimensions which customers value. The more firms are able to differentiate themselves in such a market, the less customers will view their products as substitutes, and so the higher the price suppliers may be able to charge. Ofgem’s reasoning seems to be

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<sup>22</sup> RMR IA para 1.158

that if it can reduce product differentiation in the evergreen market then it can encourage more intense price competition.

A key question, therefore, is whether less product differentiation in the evergreen market would lead to more intense price competition in this segment of the market.

If Ofgem can reduce product differentiation, then it may be more likely that tariff prices will converge upon each other. However, this point of convergence is not necessarily the competitive price. This arises because all suppliers have three broad categories of customers: the persistently disengaged, the actively engaged, and the intermittently engaged.

The greater the number of actively engaged customers that exist, the more likely it is that prices would converge on the competitive outcome. However, the greater the number of disengaged customers, the more likely it is that prices would converge on a higher level.

This is because any supplier that lowered the price of their standard evergreen tariff (the only product available) in an attempt to win new customers would also lose significant revenue from a large number of existing customers. There would therefore be less of an incentive for the supplier to cut their prices. Further, while all the suppliers differ from one another in important ways, all of them will have a customer base that is made up of these types of customers, albeit in different proportions. Consequently, they will all face this incentive, but some may face it more keenly than others.

This incentive to hold prices above perfectly competitive levels to avoid cannibalising revenue from existing customers will be weakened the more likely it is that the proposals encourage customers to switch, either between suppliers' evergreen products or between evergreen products and the fixed-term products.

It is therefore possible, as Ofgem asserts, that less product differentiation will lead to price convergence across the evergreen tariffs. This possible outcome has important implications in its own right, as we will discuss below. However, quite where the market price will settle cannot be predicted. The perfectly competitive outcome that Ofgem asserts would only be a special case. Prices will tend to competitive levels the greater the level of switching that is stimulated by Ofgem's proposals, both in the short term and on an ongoing basis. Equally, however, prices will converge at a higher level if switching is not stimulated sufficiently by Ofgem's proposals. And, of course, customer outcomes could be significantly worse than at present if switching is discouraged by the core proposals.

## The effect of the RMR evergreen proposals on competition and consumer choice

### 3.2.3 Would the proposals lead to more engagement and switching in the evergreen market segment?

As noted above, more intense competition is likely to emerge if the proposals have the effect of “enhancing effective consumer engagement”<sup>23</sup>, in other words, making customers more likely to switch between suppliers. Customers would be more likely to switch suppliers if the costs of switching are lower, or the (perceived) gains are higher. We examine these in turn.

#### *The costs of switching in the evergreen market segment*

Much of the research Ofgem has undertaken so far has focussed on the way in which greater tariff comparability combined with a simpler, standardised, set of evergreen tariffs should reduce the costs associated with comparing and switching between tariffs. Ofgem would also argue that these remedies would make it less likely that customers will make a bad decision, and so will be more likely to continue to engage in future (both in the evergreen market and the fixed-term market).

Consequently, it seems reasonable to expect that the costs of switching will fall under the Ofgem’s core proposals for customers who are not already actively engaged in the market<sup>24</sup>. However, even if tariff comparability and simplification do reduce switching costs, they only reduce those costs that are associated with comparing different offers. The proposals are unlikely to have any effect on the costs of actually moving supplier.

#### *The gains to switching in the evergreen market segment*

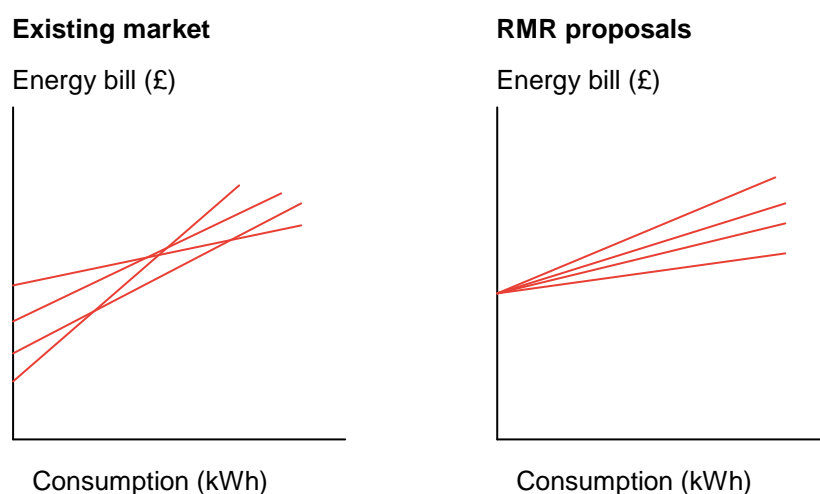
The gains to switching within the evergreen market segment are likely to be affected by three factors. First, as noted earlier, and as Ofgem acknowledge, there is likely to be tariff convergence in the evergreen tariff segment because of the restricted scope for product differentiation. Since a key driver of switching is the opportunity to make savings, then this effect of the proposals would seem to discourage, rather than encourage, switching.

Second, the imposition of a common standing charge across all suppliers means that even if the unit charges differed, the savings on the total bill (a key driver of switching) would be likely to be lower than under the present arrangements for all but the highest volume customers. Figure 3 illustrates why this may be the case: with the diversity of tariff structures that exist at present, even low consumption customers may be able to make large savings from switching.

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<sup>23</sup> RMR overview

<sup>24</sup> As noted in the previous section costs to actively engaged and informed customers could rise because of the need to re-contract to replicate the benefits they obtain on a current non-standard evergreen product.

**Figure 3. Tariff structures**

Source: Frontier Economics

Third, for certain types of customers, the gains to switching are reduced relative to the status quo because these customers want a different type of evergreen product (e.g. green evergreen product) that is now unavailable.

In summary, it is quite possible that the gains to switching could fall by more than the reduction in switching costs. If this is the case, then standard economic analysis would suggest that this would reduce the level of switching from its current levels. However, behavioural economics insights could be put forward to argue that customers may now be prepared to switch for less because there is a greater degree of security around their purchase decision (which we discuss further below).

### 3.2.4 Would the proposals lead to more engagement and switching in the fixed-term segment of the market?

The analysis above primarily considered the effect of the proposals on the evergreen segment of the market. However, it is not possible to treat the evergreen and fixed-term segments in isolation: much of the logic of Ofgem's proposals relies on them stimulating greater price competition within the fixed-term segment of the market which would then provide a constraint on pricing in the evergreen segment. In this section, we consider whether tariff comparability and the restriction of evergreen tariffs to one per payment type (and which is the default tariff for customers exiting a fixed-rate tariff) is likely to increase or diminish engagement with the fixed-term segment.

## The effect of the RMR evergreen proposals on competition and consumer choice

The proposal to introduce better tariff comparability in the fixed-term market segment (as well as the evergreen market segment) is likely to have a beneficial effect on switching costs for the reasons described above: the costs of comparison are reduced, and the risks of making an error are lessened.

The existence of the standard evergreen tariff could either promote or discourage engagement and switching. It could promote switching if it is perceived to act as a “safety net”, encouraging customers to engage with the fixed-term segment of the market. Customers would know that any mistakes they might make in choosing the tariff would be time-limited – and the proposal to introduce greater tariff comparability could also be expected to assist customers in reducing the incidence of these mistakes. In addition, customers may feel that, at present, signing up to a fixed-term contract is risky as their supplier could roll them on to an inferior contract after the fixed-term expires (which would then require additional switching costs to be rectified). The existence of a default evergreen tariff may help promote re-engagement of such customers who have become disengaged because they feel they have been exploited by remaining on an old tariff whilst others have obtained better deals. As a result, this measure could promote re-engagement. There is, though, little evidence regarding the extent to which such concerns may currently be preventing customers from choosing fixed-term tariffs<sup>25</sup> (Ofgem’s impact assessment does not provide any confirmation of whether this may be the case). In addition, this mechanism would only affect customers with moderate switching costs – those with high switching costs would never consider a fixed-term contract in the first place, while those with very low costs would not face difficulties in picking the optimal contract after the fixed-term finished.

However, it is also possible that the presence of the standard evergreen tariff will act as a disincentive to look elsewhere. This is because customers may start to view the default evergreen tariff as more regulated, and therefore safer, than the fixed-term market. Put simply, if there is a risk that the safety net could evolve into a “comfort blanket”, then this would be expected to significantly reduce switching. As Ofgem states, there may be a “...*perception (albeit incorrect) that these tariffs are regulated by Ofgem and so ‘safer’ than non-standard tariffs. This would have the effect of distorting the market since some customers may switch to standard tariffs because of the ‘Ofgem-factor’ when they would have chosen a non-standard tariff in the absence of this.*”<sup>26</sup>

Even if customers do not believe that the standard evergreen tariff is “safer”, its status as the recognised default option may mean that more customers chose it in

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<sup>25</sup> One of the participants in the qualitative research commissioned by Ofgem raised the concern that suppliers could currently “...*put you on a tariff that was extremely high*” after the end of a fixed-term contract (Creative Research (2011), *Tariff Comparability Models* pp43). However, none of the other material we have reviewed explores this issue in more depth.

<sup>26</sup> IA Para 1.244



favour of fixed-term tariffs. This is since, if the standard evergreen tariff becomes the reference point for customers choosing between tariffs, loss aversion<sup>27</sup> suggests that they may place a greater weight upon the features lost when moving from an evergreen tariff to a fixed-term contract (such as the ability to easily change supplier at any point). This is in addition to the way in which customers may be wary of fixed-term tariffs due to concerns over “lock-in” (expressed in the qualitative research carried out for Ofgem).<sup>28</sup>

It is entirely possible that both effects could prevail over time – an initial re-engagement by customers who now have the confidence to do so, followed by an evolution to remaining on the evergreen tariff because it is perceived as the officially sanctioned tariff.

Without further research into consumer switching behaviour, it is not possible to determine what the overall effect could be. However, remedies that seek solely to increase transparency of pricing (for example, standardised tariff price labels) might help assuage customers’ fears over entering the fixed-term segment, while eliminating the prospect that the single evergreen product would come to be seen as the “safe” option.

### 3.2.5 The effect of different levels of switching within and across market segments

The discussions above enable us to set up a summary of possible outcomes that could emerge from Ofgem’s core proposals, which we set out in Table 4.

As Ofgem has asserted, the increasing homogenisation of evergreen products under the proposals would be likely to lead to a convergence of prices in that segment of the market. Consequently, despite the potential reduction in switching costs due to better comparability and restrictions on tariffs in the evergreen segment, the gains to switching would also fall. The extent to which the gains fall relative to the costs, coupled with the behavioural impact of the “safety net” of the evergreen tariff will determine the extent of switching in this segment.

On the one hand, the reduction in switching costs, the perception of the evergreen product as a safety net, and the reduction of choice within the evergreen segment could all induce an increase in switching from the evergreen segment into the fixed-term segment, and continued switching within the fixed-term segment. The greater the number of active customers, the more likely it is that prices in the fixed-term segment should constrain the prices in the evergreen segment, since a widening of prices across the two segments should be held in

<sup>27</sup> See Ofgem (2011), *What can behavioural economics say about GB energy customers* for an overview of the concept.

<sup>28</sup> Creative Research (2011), *Tariff Comparability Models*



check by the increased probability of switching from the evergreen segment into the fixed-term segment that would be created by Ofgem's proposals. Equally, if it transpires that customers generally prefer evergreen products to fixed-term products, but are willing to switch evergreen products for relatively small gains, then this should exert a downward pressure on the prices of evergreen products, and this should also act as a constraint in the fixed-term segment. The greater the prospect of these increases in switching materialising, the more likely it is that the proposals will offer a benefit relative to the status quo.

However, on the other hand, if the gains to switching in the evergreen market segment are smaller than the costs, and/or that customers do not see the evergreen product as a safety net (or worse, perceive it as a comfort blanket), then switching will not increase and may decline relative to the status quo. If this is the case, fewer customers will switch within the evergreen segment, and fewer customers will switch into the fixed-term market, and both these effects can be expected to lead to evergreen tariffs converging on a higher price. Moreover, the less willing and able customers are to switch between the evergreen and fixed-term products, the higher the risk of a "two-tier" market developing, where prices in the two segments diverge.

**Table 4.** Range of possible outcomes under Ofgem's core proposals relative to the status quo

	Best case	Improvement	No change	Deterioration
Evergreen segment	Forced switching into this segment at the outset has a positive impact on engagement	Forced switching into this segment at the outset has a positive/neutral impact on engagement	Forced switching into this segment at the outset has a neutral impact on engagement	Forced switching into this segment at the outset has a negative impact on engagement
	Switching costs fall due to simplicity and comparability	Switching costs fall due to simplicity and comparability	Switching costs fall due to simplicity and comparability	Switching costs fall due to simplicity and comparability
	Gains from switching fall due to tariff convergence but "safety net" encourages switching for less gain	Gains from switching fall by more due to tariff convergence (and/or "safety net" does not encourage more switching for less gain)	Gains from switching fall by more due to tariff convergence (and/or "safety net" does not encourage more switching for less gain)	Gains from switching fall by more due to tariff convergence (and/or "safety net" does not encourage more switching for less gain)
	Leads to an increase in switching in this segment	Leads to a fall in switching in this segment	Leads to a fall in switching in this segment	Leads to a fall in switching in this segment

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Fixed-term segment	“Safety net” encourages more switching into this segment from the evergreen segment	“Safety net” encourages more switching into this segment from the evergreen segment, and total switching is higher than it would have been under the status quo	“Safety net” does not stimulate a significant increase in total switching	“Safety net” turns into a “comfort blanket” and switching declines relative to the status quo
Outcome	Greater intensity of competition across and within each segment	Greater intensity of competition in the fixed-term segment will discipline behaviour in the evergreen segment	The proposals will have institutionalised the existing pattern of a two-tier market between active and inactive customers	Development of a more significantly marked two-tier market, with limited competition in the evergreen market

Source: Frontier Economics

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To evaluate the most likely outcome, more research would need to be undertaken on the extent to which customers of different types would be willing to switch between the fixed-term and evergreen segments of the market. This research would need to be more considerably more advanced than Ofgem has undertaken to date. In order to justify restrictions on tariffs in the evergreen market, customers in the survey would need to respond to a number of plausible situations that they could face if Ofgem's proposals were implemented, so that prospective behaviour could be properly analysed under a range of scenarios. This would need to include the scenario that customers would be forced to move from products and tariffs that they have actively chosen. We discuss these data issues in more detail in section 3.4

In the absence of new research, our view is that there is a serious risk of adverse outcomes emerging from Ofgem's core proposals. The policy itself carries the risk of poor outcomes, and when the initial cost of the upheaval of widespread forced tariff change is added in, then the scope for customers to become even more disengaged and suspicious of the energy market increases significantly.

In its draft IA, Ofgem does not quite admit the possibility of these types of outcomes, but does go on to say that if undesirable outcomes emerge, then it leaves itself open the option to apply further regulation:

*“The development of a two tier market would be an undesirable outcome, but may be no worse than the status quo in which sticky customers continue to pay more than non-sticky customers. In any case, the emergence of a two-tier market would be immediately apparent as we would continually monitor prices. We would take action to address any concerns relating to the possibility of co-ordinated effects and any other unintended consequences arising from the tariff simplification remedies”<sup>29</sup>*

This line of reasoning is troubling for two reasons. First, it is placing significant reliance on some rather limited evidence and selected theoretical propositions to assert that its proposals may be no worse than at present. This faith in its own IA, despite its many omissions, is suggestive of some of the types of biases and irrationality that behavioural economics theory predicts that regulators can be prone to suffer from, which can lead them to make ill-informed decisions that do not promote economic efficiency<sup>30</sup>. The two biases that have been identified that are particularly relevant in this case are “optimism bias” that causes regulators to under-estimate the probability of a bad outcome; and “confirmation bias” which arises when regulators become wedded to a policy or proposal to the extent that contrary evidence is ignored or downplayed.

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<sup>29</sup> IA para 1.168

<sup>30</sup> Behavioural economics: implications for regulatory behaviour, by James Cooper and William Kovacic, *Journal of Regulatory Economics*, 2012, 41:41-58

The second troubling aspect of this paragraph is that Ofgem appears to permit itself the option to re-intervene in the market and moreover gives itself considerable latitude to do so (in response to “any unintended consequences”). This catch-all clause is worrying for three reasons:

- it potentially renders Ofgem’s IA completely meaningless because it implies that if this policy package doesn’t work, then Ofgem will find another policy or intervention that will;
- it suggests that the further remedies that Ofgem has in mind are the re-regulation of the sector rather than a set of policies that will make competition work; and
- it implies that Ofgem has assumed that the present proposals and all the (as yet undefined) future policies to put regulatory sticking plaster over the unintended consequences of the previous policy initiative will yield a better outcome over the long term than any other alternative approach that could be implemented at this point in time.

Before Ofgem embarks on a policy route that carries a high risk of evolving into re-regulation of the sector, it would be prudent to evaluate remedies that avoid the downside risk associated with the present proposals, and which are pro-competitive in intent, and potential effect. It is to two of these possible alternatives that we now turn.

### 3.3 Initial assessment of the counterfactuals

The framework we have outlined in this section is also relevant for the assessment of the two counterfactual options. However, any assessment of these options is limited to the same extent as our assessment of Ofgem’s proposals, by the availability of data and evidence.

Nevertheless, it is possible to understand where the balance of risks lies with these counterfactuals relative to the Ofgem proposal, which we discuss in this section.

#### 3.3.1 Price comparison only

##### *Impact on choice*

This counterfactual removes the restriction on choice that is a feature of Ofgem’s proposals. As we noted in the previous section, Ofgem’s proposal to restrict evergreen products imposed an additional cost on choice – previously the evergreen tariff choice imposed a one-off switching cost on customers until the customer chose again, whilst the proposals now require the cost to be re-incurred at regular intervals. As a result, any customers that are forced to move from evergreen to fixed-term products would be left worse off. For some, the

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additional cost imposed could leave the customer better off by remaining in the standard evergreen segment of the market, and actually becoming less engaged with the market. Under the price comparison only option this risk would be eliminated.

This counterfactual would also avoid the inefficiencies associated with the regulation of the standing charge.

Finally, the price comparison approach should be able to provide some important evidence about customers' willingness to learn, and ability to understand tariff choices when presented with clear information. This experience will be of great value when considering the most effective ways to encourage customers to shift to time of use (ToU) tariffs after smart meters have been rolled out.

This counterfactual therefore avoids many of the potential adverse effects of the Ofgem proposals, whilst also providing a potential benefit in being able to realise the benefits of smart metering more quickly than under the Ofgem proposals.

### Competitive effects

The key driver of competitive effects is the level of switching that each policy option is able to promote. Ofgem's survey evidence suggests that this option does not encourage switching by as much as Ofgem's proposal which combines this option with restriction on choice<sup>31</sup>. If this is true, then this would not necessarily imply that Ofgem's proposals should be preferred, for two reasons. First, the objective of the policy framework should be to encourage sufficient switching to ensure that all customers are benefitting from competition, even the non-switchers. That is, there should be enough switching within and across both market segments to discipline suppliers' pricing behaviour. This does not require all customers to be active, but does require a sufficient number to be so. Therefore, within a certain range, any differences in declared propensity to switch in the survey data may have a relatively limited competitive benefit.

Second, the survey data does not provide insight into several extremely relevant areas for the purposes of an IA:

- the reaction of customers to forced switching upon implementation of the policy, which could reduce engagement;
- whether customers would switch if the gains from switching in the evergreen market reduced due to price convergence; or

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<sup>31</sup> Although Stephen Littlechild argues that this survey result is misleading, and that of the two elements of Ofgem's package, tariff comparability is the more powerful driver of switching. See *Ofgem's Procrustean Bed: a response to Ofgem's Consultation on its Retail Market Domestic proposals*, 23<sup>rd</sup> January 2012.

- whether customers increasingly perceive the evergreen tariff as a “comfort blanket” and so become disengaged from the market

Without the answers to these questions it is difficult to draw definitive conclusions. However, it is possible to assert that the price comparison only counterfactual eliminates the risk of all of the adverse competitive outcomes associated with Ofgem’s proposals. It may also remove the potentially beneficial effects of the “safety net” but if this has only a marginal effect on switching relative to this counterfactual, then the competitive benefits of this effect will be commensurately marginal.

### *Summary*

This counterfactual eliminates the risk of the worst case outcome under Ofgem’s proposals. Since we regard that risk to be highly significant, in our view this option should be given further considered assessment.

It is possible that this option may also reduce the prospects of achieving the best case outcome under Ofgem’s proposals. To assess whether this is likely it will be important to undertake further analysis of customers’ likely responses, which we discuss in more detail in section 3.4.

## 3.3.2 Airline options

### *Impact on choice*

The airline options counterfactual would lead to a range of evergreen tariffs somewhere between the RMR core proposals and “price comparison only”. The extent of choice will depend upon the number of options which suppliers are able to offer, but even a small set of options (such as dual fuel, online and green) may be sufficient to encompass the evergreen tariffs used by the majority of customers.

However, the limitations regarding the structure of tariffs (an Ofgem-mandated standing charge and a single unit rate) would remain under this counterfactual, which may lead to the distortions we described that are associated with the Ofgem proposals. In particular, the airline options model may still lead to a reduction in the uptake of ToU tariffs, as anything more complex than E7 would not generally fit into the scope of a standard tariff<sup>32</sup>.

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<sup>32</sup> It is our understanding that, as with the core RMR proposals, the airline options model would not permit time-of-use standard tariffs (beyond E7 and the derogation for existing E10 and DTS tariffs). However, if more advanced time-of-use tariffs were permitted as an option, this would mitigate the concern that the reforms could slow the take-up of such innovative tariffs.

This counterfactual would therefore lead to less of a loss of choice than the RMR core proposals, but would be associated with the same risks regarding the standardised tariff structure.

### *Competitive effects*

A number of factors are likely to affect how the airline options model could affect switching within and from the evergreen market. Firstly, the introduction of more tariffs (than under the core proposals) could lead to an increase in the complexity of tariff choice and switching costs. This is supported by the quantitative survey carried out for Ofgem, which found that customers were less able to identify the cheapest tariff under an airline options approach to the case where each supplier offered only one tariff. However, it is also quite possible that, relative to the status quo, the airline options model is seen as simpler, and promotes more switching – potentially enough to ensure all customers benefit from greater competition.

In addition, the greater diversity of tariffs available within the evergreen segment (relative to the RMR core proposals) may encourage customers to switch within the evergreen segment.

The impact upon switching to the fixed-term segment is also ambiguous. With more choice available in the evergreen segment, customers might feel that there is less need to switch to the fixed-term segment under this model than under the RMR core proposals. Equally, whether the increase in the number of evergreen products reduces or enhances the perception of them as safety nets or comfort blankets is hard to judge a priori and would need further research to investigate further.

### *Summary*

In many respects, the airline options model falls between the RMR core proposals and the price comparison only model. It could mitigate much of the loss of customer welfare that could stem from reduced choice and, as a less extreme intervention, is likely to have less of an impact upon consumer engagement (for better or worse).

However, the fixed standing charge element of the proposal remains unaltered in this counterfactual. If the costs associated with this turned out to be a significant part of the costs of the core proposals, it is unlikely that the overall evaluation of the airline options model would differ much.



### 3.4 Key questions needed to inform an understanding of the effect of the proposals on choice and competition

There are a number of important questions that are presently unresolved in the Draft IA.

- What is the cost to customers of forcibly removing them from the tariffs they are presently on to the standard evergreen products, plus the costs of regular switching decisions that are needed to replicate what they presently consume, and would those costs lead them to become disengaged from the market?
- What is the likelihood that customers become so used to simplicity that they cannot evaluate time of use tariffs when they are introduced, to such an extent that a central plank of government policy is not realised?
- What will be the switching behaviour of customers if prices converge in the evergreen market segment, as Ofgem asserts that they will. Will customers remain engaged and switch for much smaller gains, or would they become even less engaged??
- Will customers view the evergreen tariff as a safety net that gives them confidence to explore the fixed-term market? Or would they perceive it as a regulatory comfort blanket and stop engaging with the fixed-term segment of the market?
- What are the impacts on entry and expansion by new entrants and smaller players?
- To what extent can other counterfactual options promote greater engagement and switching with less downside risk?
- Given the answers to these key questions, what are the range of possible competitive outcomes that could arise if the proposals, or other counterfactual options are considered?

In our view it is imperative that Ofgem addresses these questions in order that it can properly satisfy itself that it is acting in the best interests of customers – not just in terms of its intent, but in terms of fully evaluating the expected economic effect of each element of the policy package, both in isolation and as a bundle.

In the remainder of this section, we consider what information would be required to gain an understanding of the effect of the proposals, and how much the research carried out to date by Ofgem can tell us.

**The effect of the RMR evergreen proposals on competition and consumer choice**

### 3.4.1 Required information

A full impact assessment would require examining how customers will react to the proposals, how firms may react in turn, and what the welfare consequences may be for consumers. Setting out a full specification for the research that would be required is beyond the scope of this report. Instead, we lay out below the high-level issues that such research would need to address.

#### *The reaction of customers to the proposals*

For a full impact assessment, it will be necessary to determine how Ofgem's proposals (and the various alternative options) would affect customer decision-making. According to Ofgem,<sup>33</sup> the decision-making process of a customer can be broken down into the following three stages:

- **access** – consumers find information about their tariff and other available tariffs
- **assess** – consumers evaluate the information and decide which deal is best for them
- **act** – consumers choose the best deal

To evaluate the effects of the proposals, it will be necessary to see how each of these stages is affected. Will features of the proposals lead to a greater number of customers engaging with the market in the first place? Will those customers that do engage be in a better position to choose the tariff that is correct for them? And will this lead them to switch tariffs or supplier (and to what type of tariff – for example, evergreen or fixed-term products). Answering these questions will require surveys of customers.

In order to fully determine how the proposals could affect the dynamics of the market, customer switching behaviour should be assessed for each combination of customer type and current tariff (for example, non-vulnerable engaged customers currently on fixed-term tariffs, or vulnerable passive customers currently on basic evergreen tariffs). This segmentation of customers would help identify any distributional effects, and would also be required to determine how each segment of the market would be affected (for example, whether customers currently on fixed-term tariffs will behave differently to those currently on evergreen tariffs).<sup>34</sup>

<sup>33</sup> Ofgem (21 March 2011), *What can behavioural economics say about GB energy consumers?*. The framework originally appeared in OFT (March 2010), *What does behavioural economics mean for competition policy?*

<sup>34</sup> Due to switching costs, it is likely that there will be an element of path dependency in customers' reactions to the proposals – the tariffs chosen by customers will depend upon the tariffs which they are currently on. If all customers of a particular type (regardless of the tariff they are currently on) were considered together, this would likely conceal such differences.

## The effect of the RMR evergreen proposals on competition and consumer choice

When carrying out this type of research, it will be necessary to determine how customer switching behaviour may vary under different price differentials between tariffs (rather than just under current prices). This is to allow the longer term effects of changes in tariff differentials upon switching to be estimated. In addition, careful framing of questions would be required to test for the “safety net” and “comfort blanket” effects we described in section 3.2.4.

### *The reaction of firms*

Research along the lines described above could give a good idea of the first-round effects of the proposals upon consumers. However, the final effects of any changes in the market will depend upon the reaction of firms. For example, any increase in switching behaviour could lead to greater price competition between firms, leading to lower tariffs for all consumers (conversely, if the proposals were to lead to existing customer inertia becoming entrenched, then this might lead to prices converging to a higher level).

One way to answer these questions would be to construct a quantitative economic model, where suppliers dynamically change their competitive strategies in the light of expected consumer behaviour. This could be calibrated with information on existing product types, customer types, and switching behaviour, and then used in conjunction with the output of the consumer research described above to determine how this might affect competition<sup>35</sup>.

### *The welfare consequences for consumers*

It will also be necessary to determine how consumers value the different types of tariff. This is especially important for consumers currently on “non-standard” evergreen tariffs who, under Ofgem’s proposals, would be forced to move on to either fixed-term tariffs or the standard evergreen tariff.

This would require understanding how much customers may value “non-standard evergreen” tariffs (e.g. with online or dual fuel discounts) over the standard evergreen or “custom fixed” options. As part of this, a value would need to be placed upon the inconvenience consumers may associate with having to regularly renew a fixed-term tariff.

This type of research would tie closely into the consumer switching research we describe above (since consumer switching behaviour is partially driven by the expected gains). Conversely, the presence of switching costs and inertia mean that it may be difficult to discern the preferences of customers from their current

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<sup>35</sup> This kind of model can be seen as analogous to merger simulation models that are often used by regulatory and competition authorities. These models embody a stylised representation of the industry in question, and the impact of changes in ownership structure are assessed relative to the status quo. In a similar vein, the impact of regulatory changes can be assessed using these type of models.

tariff choices (customers might not be on their “preferred” tariff due to the presence of switching costs).

### 3.4.2 Research to date

In this section, we summarise some of the research that Ofgem has carried out so far, and how this fits into the framework outlined above.

#### *Tariff Comparability Models consumer research*

This qualitative research<sup>36</sup> (carried out on a sample of 106 consumers) elicited the attitudes of customers to a variety of different tariff models:

- The RMR core proposals (with and without common standing charges);
- a price comparison only model; and
- an “airline options” model.

Overall, the study concluded that all these options would be likely to make it easier for customers to compare tariffs, which would have the potential to encourage switching. In the terminology of the customer choice framework, the options may help customers’ assessment of the options available to them. However, it is not possible to conclude whether this would result in significant numbers of consumers acting upon this.

In addition, as the report states, “...it has not addressed the question of how to encourage sticky customers to engage with tariff pricing information tables in the first place” – i.e. how to ensure that customers have access to the market in the first place. It is not possible to quantify the benefits of the proposals without having an understanding as to how many currently inactive customers may become engaged with the market.

#### *Consumer reactions to varying tariff comparability*

This study<sup>37</sup> applied a more quantitative methodology to a sample of 2,202 consumers in order to determine how they made tariff choices. The first section involved consumers being asked to pick the optimal tariff (based on a hypothetical consumption figure) from a table. Each customer carried out this exercise four times, with tariff tables for the following situations:<sup>38</sup>

- A. A fixed standing charge with a variable unit rate per supplier

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<sup>36</sup> Creative Research (2011), *Tariff Comparability Models*

<sup>37</sup> Ipsos MORI (2011), *Consumer reactions to varying tariff comparability*

<sup>38</sup> Economy 7 customers were presented with a similar set of tariffs which also took day/night rates into account.

- B. A fixed standing charge with a variable unit rate per supplier, plus a price comparison guide (giving average monthly costs for low/medium/high users under each tariff)
- C. A variable standing charge and a variable unit rate per supplier
- D. A variable standing charge and a variable unit rate per supplier, plus a price comparison guide

It was found that more consumers were able to correctly identify the best deal when faced with a fixed standing charge and a price comparison guide than the other options (option B). In contrast, customers were presented with an “airline options”-type tariff, with each of the four suppliers in the table offering discounts or surcharges for green energy, internet access and dual fuel. Consumers found it harder to choose the cheapest tariff than when they were only presented with one tariff per supplier.

As with the more qualitative survey, this evidence suggests that some combination of a price comparison guide and a simplified tariff structure can help consumers assess the tariffs available to them. However, as we have already noted, it is not possible to determine whether consumers are more likely to engage with the market in the first place, or whether this will lead to greater levels of switching. Moreover, whilst the costs of comparing tariffs have fallen, switching also depends on the gains from switching, and these will have fallen as well. The survey did not evaluate willingness to switch at different price differentials, which is crucial for comparing the effect of the different options on switching behaviour and competitive outcomes.

The final section of this research looked at consumers preferences regarding the different types of tariffs available. Respondents generally showed an interest in additional features, with a majority of customers indicating that they would probably choose dual fuel and internet access options, and a sizable proportion (10%) stating that they would pick a “green” tariff. However, the survey does not produce an estimate of the value that customers attach to these features, which would be relevant for such a significant change in product choice as envisaged under the Ofgem proposals.

Consumers were also asked whether they would choose variable, tracker or fixed tariffs. Only 6% of customers indicated that they would probably chose a variable tariff which is a puzzling result (as noted by Littlechild, around 75% of consumers are currently on such tariffs). This significant gap between stated preference and revealed preference is a feature of the results that should be investigated further.

Overall, this is a useful piece of research which can shed some light on the way in which customers assess tariffs when the details are readily available to them. However, it provides no information on whether the proposals might lead to greater customer engagement, and little on how switching behaviour may differ.

## The effect of the RMR evergreen proposals on competition and consumer choice

While the final part of the study provides some insight into the value consumers may place upon different types of tariff, it is not possible to place a value upon this.

### *Consumer First panel workshops*

A round of workshops<sup>39</sup> was carried out with Ofgem's Consumer First panellists in order to understand the information consumers need to help them review their energy options, and how they would prefer this to be presented. Four pieces of information were discussed with panellists: annual statements, bills with added annual statement information, price increase notification and tariff information labels.

This study includes a typology of customers (engaged, reactive, passive or disengaged), which could be helpful for building up the evidence on customer switching we described above.

The research provides some evidence on how customers could be encouraged to engage more with the market. However, as a qualitative survey, it is not possible to draw conclusions regarding how effective some of the proposals in the RMR could be.

### **3.4.3 Summary**

The research carried out by Ofgem to date is mainly concerned with determining how customers' assessment of tariffs may be affected by some of the RMR proposals.

However, there are currently significant gaps in the evidence base for the proposals. Very little has been done to examine how the proposals may change consumer engagement (for example due to the appearance of a "regulated" tariff), or how switching behaviour will ultimately be affected. No quantitative work appears to have been carried out to support Ofgem's assumptions regarding the competitive impact of the proposals. Finally, it is not currently possible to determine the value consumers' place on the variety of tariffs available at present.

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<sup>39</sup> Ipsos MORI (2012), *Ofgem Consumer First Panel Year 4 – Findings from first workshops (held in October and November 2011)* - <http://www.ofgem.gov.uk/Sustainability/Cp/CF/Documents1/Ofgem%20Consumer%20First%20Panel%20Year%204.pdf>

## 4 The direct costs of implementing the proposals

As explained above, it is by no means clear that the proposals will deliver a more competitive market for customers. Even if this were the case, though, any benefits would need to be weighed against the costs incurred by suppliers (which will ultimately be passed through to customers) and Ofgem. In this section we only report preliminary estimates for the first of these.

### 4.1 Additional costs incurred by suppliers

Ofgem acknowledges that the proposals will lead to one-off implementation costs for suppliers.<sup>40</sup> In addition, there may also be increased ongoing costs (for example due to the increased customer contact that may be required for fixed-term products).

In order to gain an idea of the impact of the proposals upon costs, we asked the “big six” suppliers to estimate the costs of complying with the proposals and the counterfactuals. In the time available to complete this report, it has been impossible to develop a fully standardised set of costs across all suppliers that are prepared on an equivalent basis. Instead, we asked suppliers to indicate how various categories of cost (only considering indirect costs) would change under Ofgem’s proposals, compared to the actual figures reported in their 2010/11 segmental accounts. Suppliers were asked to split these cost increases between one-off and ongoing elements.

Many of these costs will vary according to the number of customers who choose to switch tariff. Suppliers based their cost estimates upon their own internal forecasts of customer behaviour, which will not be consistent with each other.

Since our estimates are necessarily preliminary and indicative, we recommend that Ofgem should investigate these costs in more detail to inform its impact analysis.

#### 4.1.1 Results

Four suppliers were able to provide us with cost data, which we summarise below. All of the suppliers stressed that these were only initial estimates, and omitted various types of cost (for example the impact of a greater number of fixed-term customers on hedging) were not included.

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<sup>40</sup> RMR IA para 1.172



### *One-off costs*

Three of the suppliers reported that Ofgem's proposals would lead to a one-off increase in indirect costs of between 0.5% and 2% of their total domestic supply business indirect costs (which in turn account for between 10% and 20% of total operating costs). The most significant cost items related to customer correspondence (informing customers of the changes to tariffs) and changes to IT and billing systems.

One supplier reported a significantly larger increase (a 5.4% rise in indirect costs), almost entirely due to increased customer contact costs. This appears to be driven by an assumption that the vast majority of customers will quickly switch to fixed-term products. Other suppliers' estimates seem to have been based upon considerably lower penetrations of fixed-term products. This highlights the importance, both for Ofgem and suppliers, of forecasting customer behaviour in response to any changes to tariffs.

### *Ongoing costs*

Three suppliers provided us with estimates of the increase in ongoing costs relating to the proposals, which ranged between 1.7% and 3.0% of indirect costs (the latter, higher, result was again driven by the assumption that more customers would move to fixed-rate tariffs). As with the one-off costs, costs associated with sales and marketing are the main component of this.

### *Other tariff models*

Two suppliers provided estimates of costs under the two counterfactual models (airline options and price comparison only). Both the supplier's sets of figures indicated that the incremental costs would be lower under the price comparison only option than Ofgem's proposals. However, one supplier expected that the airline options approach could be more expensive than the Ofgem's proposal (due to more complex tariffs) whilst the other expected that it would be less expensive (due to less predicted switching).

## *The direct costs of implementing the proposals*



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