“The Retail Market Review - Findings and initial proposals” (RMR)

Response to consultation from Catherine Ball, Morten Hviid, Graham Loomes and Catherine Waddams

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Summary of response

We encourage the move towards tariff simplification, but we are conscious of a risk that this approach could provide companies with greater opportunities to segment the market. This could lead to more detrimental outcomes for disengaged consumers even while it increases activity and improves outcomes for those consumers willing to engage with the market. The lack of spill-overs/externalities from active to disengaged consumers leads to some concerns for vulnerable consumers who may require additional protection. Additional strategies, for example those which aim to reward agencies who facilitate greater engagement and encourage competition between evergreen tariffs, will almost certainly be required to protect and promote consumers’ interests more generally.

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Disclaimer: Our response will cover proposal 1 and questions 1 to 7 only. We have not considered the other proposals. The response represents the views of the named authors.

1. Consumer (dis) engagement

Ofgem's report suggests that a large proportion of energy consumers are 'permanently disengaged' (20-30%) or 'disengaged' (20-30%). It also suggests that it would be better for many of these consumers if they switched at least occasionally because they would probably save money – quite possibly £50-£100 p.a. by switching tariff with current supplier, maybe £150-£250 by switching supplier (see RMR Fig 2.10). It would also be better for many non-switching consumers if greater engagement led to lower prices (though this would mean that actual switchers get less benefit). Finally, it is perceived by Ofgem that engagement/switching is hampered by the complexity of tariffs.

Preliminary analysis from our 2011 consumer survey supports most of the findings of consumer harm reported in the RMR (**Question 1**). In particular, we find that 17% of consumers are permanently disengaged, 43% disengaged, 12% are passive, 13% reactive and 16% proactive, based on Ofgem's definitions[1].

There is also evidence that the "never" switched are not always satisfied with their current supplier. Table 1 shows the levels of satisfaction with their supplier of consumers who have not switched (in the last three years) across several dimensions and overall.

Table 1: Responses from never-switchers when asked about electricity suppliers performance on the following areas.

	Suppliers performance on area (% of 1172 never-switchers):					
Area	Very bad	Bad	Neither good nor bad	Good	Very Good	Don't know
Price	3.5	10.9	34.6	38.1	7.5	5.3
Customer service	0.8	4.2	24.8	48.6	14.4	7.3
Flexibility of payment options (i.e. the ability to pay by preferred method)	0.9	2.1	9.3	64.2	19.3	4.3
Accuracy of billing	1.5	5.2	16.1	53.0	16.1	8.0
Quality of billing (how easy bill is to understand)	1.6	7.2	14.4	53.8	17.8	5.1
Environmental issues	0.2	3.0	28.1	25.9	5.1	37.7
Overall	0.5	3.2	20.0	62.4	12.8	1.2

Source: CCP Consumer Survey 2011

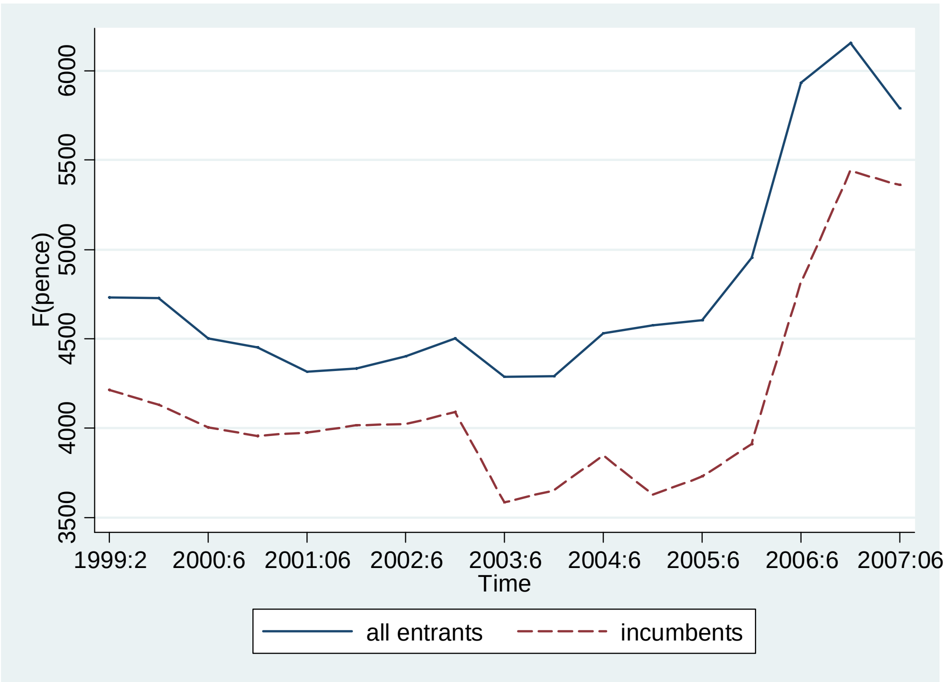
[1] Our analysis of reactive and active consumers is based upon a three year window as opposed to the one year window used for RMR table 2.10.

However, there does not seem to be clear evidence that disengagement is caused by a lack of information. Rather, given that almost as many consumers are reactive as proactive switchers, the cause of disengagement may be that the switching task lacks salience or suffers from status quo bias – 92% of those in our survey who had never switched agreed with the statement “Once I find a product or service that I think is OK, I tend to stick with it” compared to 86% of those that had switched at least once in the last 12 years, a statistically significant difference in proportion..

2. Tariff proliferation

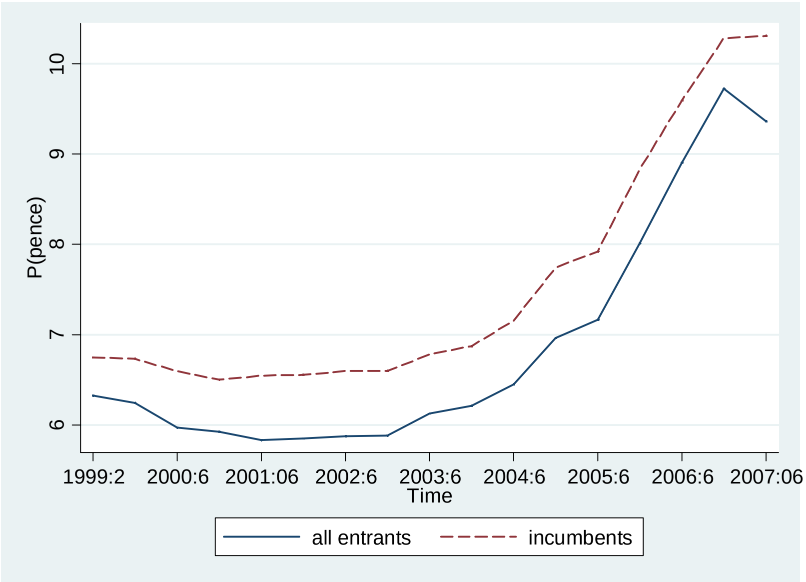
Tariff proliferation is common and may be a way for companies to increase differentiation and segment the market (in terms of usage). As the market developed, companies introduced a much wider range of tariffs (reflected in the ratio of fixed charge to energy charge) when consolidation among the ‘big 6’ was complete in 2003. Figures 1 and 2 show the evolution of the standing charge and the energy charge, from market opening until 2007.

Figure 1: Annual standing charge (pence per year) for standard payment standard electricity tariffs



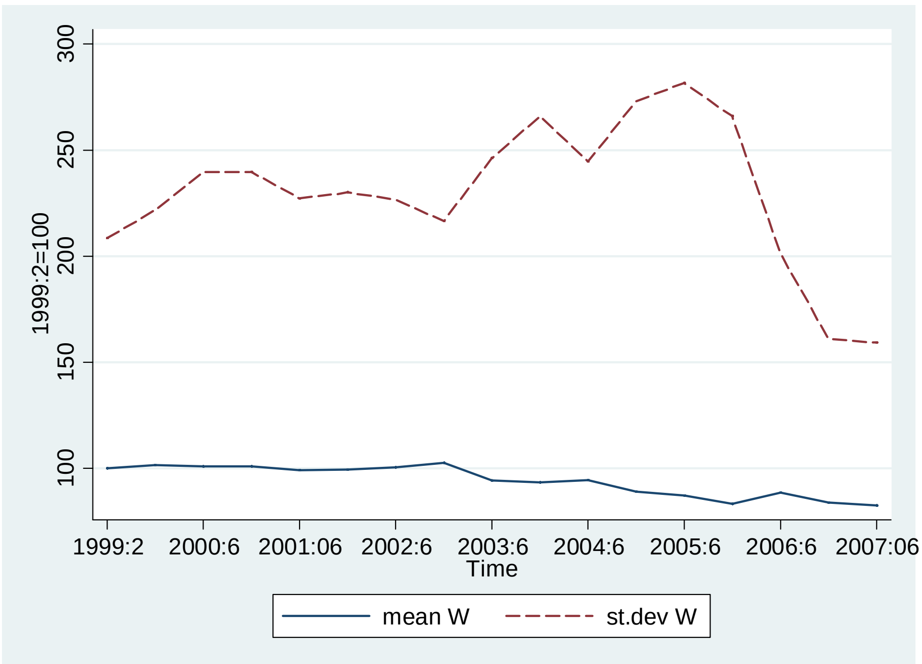
Source: CCP analysis of tariffs

Figure 2: Energy charge (pence per kWh) for standard payment standard electricity tariffs



Source: CCP analysis of tariffs

Figure 3: Ratio of annual standing charge to energy charge (W=fixed charge/energy charge) : mean and standard deviation for standard credit electricity



Source: CCP analysis of tariffs

Figure 3 shows how the variance of this ratio increased over 2002-2005, representing both tariff innovation and effective 'division of the market' according to consumption levels by different companies. Most of the increased variation was within regions, with incumbents having a relatively low ratio of standing charge to running rate (attractive for low consumption levels) and entrants using a high ratio, appealing more to high consumption. After the variance decreased sharply. Nevertheless a large variation in effective standing charges remains, as the figure for the standard tariffs for direct debit payment for electricity in the Eastern region show (table 2).

Table 2: Approximate effective standing charge and running rate, standard direct debit electricity, Eastern Region, May 2011

Company	'effective' standing charge = F, £s per year	Running rate = p per kWh	Ratio of standing charge to running rate = F/p
Electricité de France	46	0.116	399
npower	0 (-16)	0.134	0 (-122)
EOn (incumbent)	96	0.110	872
Scottish Power	53	0.111	476
Scottish and Southern	30	0.116	261
British Gas	98	0.101	970

Source: CCP analysis of Consumer Focus factsheets for all companies except British Gas, calculated directly from tariff information on website.

These variations mean that the best deal depends on how much energy is used; for example someone using a very small amount of energy, say 2,000 kWh, would do best with npower (total bill £252 compared with £316 with the incumbent). While a user of larger quantities, say 8,000kWh, would be better off with British Gas (£866 compared with £1072 with npower). It is such differences (along with the variety of special offers) which give rise to Ofgem's concerns.

Whilst we believe that the simplification of evergreen tariffs will increase comparability (with some caveats discussed later) we wonder why the proposal does not go further and prohibit the use of fixed-term products, so that each supplier can only offer one tariff per payment method. There are two reasons for promoting this idea. Firstly, it is not clear that consumers "value" a choice of tariffs or benefit from tariff innovation. As shown above, there is some evidence that companies have used tariff proliferation to segment the market. When the non discrimination clauses were first introduced, companies pressed Ofgem to allow special deals, and these have become the focus for competition for active customers; their temporary nature is often poorly understood, especially by some 'vulnerable' consumers. Given this experience, Ofgem may wish to revert to its original proposal of disallowing special deals. This would dampen competition for some parts of the market, but may strengthen competition for the market as a whole.

Secondly, there is a concern that companies will continue to segment the market between active and passive consumers, i.e. whilst "active" consumers will take advantage of competitively priced, fixed-term products, "permanently disengaged" consumers may become stuck on less competitive, evergreen products. The introduction of the non-discrimination clauses gave rise to much greater variation between 'standard' and 'special offers', and this effect may be repeated. It will depend on what happens at the end of the special offer period. Ofgem suggests that consumers automatically default to the evergreen tariff, but may proactively choose to move to another fixed term offer. Active consumers will do so, and continue to seek good deals. Those consumers who are reactive, but have been persuaded to switch supplier through a temporary deal, will remain with the new supplier on its evergreen tariff. By definition this will be more profitable for the company (more expensive for the consumer) than the special offer, else the special offers would not attract consumers. The new regime may encourage excellent special deals, but if it does not stimulate competition between evergreen tariffs, the result for inactive consumers will be no better; indeed if it induces more such consumers to switch supplier and then default onto less good evergreen tariffs, the situation may merely enable clearer differentiation between active and passive consumers.

Given the current bifurcation of the market, Ofgem's decisions will inevitably mean that either the passive or the active consumers will be immediately worse off from intervention. If special deals are banned, or the long term profits from those who switch to them are reduced in the long run, there will be fewer and less good deals, and companies will market them less energetically. Ofgem may want to be careful about sending messages which discourage active consumers from seeking the best deals because there are fewer available.

However the new presentation of tariffs may have the positive effect of persuading some currently inactive consumers to engage with the market and seek better deals. This should improve both their own economic welfare through lower prices, and the functioning of the market via greater pressure on suppliers. But Ofgem will want to monitor carefully the characteristics of those who remain disengaged. One possibility is that while this group shrinks, it retains an increasing proportion of those who the regulator considers vulnerable and in need of special protection.

Compared with the current situation, those who accept a special offer should be no worse off that they would have been without changing, if they revert to an evergreen offer no worse than the one they were previously paying. However this again raises the question of what are the companies' incentives to offer better deals, if they do not enable them to 'capture' some essentially passive consumers?

Assuming any proposal requires balancing some consumers becoming more active, against the possibility that the inequality would get worse for those who stayed inactive, and that the proportion of vulnerable consumers in the non-active group may increase. (**Questions 2, 3 and 4**).

3. Structure of evergreen tariffs

Ofgem's proposal to determine the fixed element of the evergreen tariff (and the comparator for all tariffs) involves them deeply in tariff setting and entails the duty to ensure that the balance between fixed and energy related tariffs is appropriate. In some ways this intervention imposes greater control than when the level of tariffs was regulated, but companies retained some discretion over the balance between standing and energy charges. Any standing charge which is not cost based will introduce and embed distortions in the market. Yet the relevant costs may be difficult to determine, and may differ between companies, particularly given the considerable variation in current charges (see table 2 above). Determining the appropriate charges will require detailed analysis of company costs and allocation of overheads between consumer and energy elements. Companies may argue for high standing charges, so that the price on which they are competing is as low as possible and they have more assured revenue. This will reduce the amount over which companies are competing (the energy element) and may dampen rivalry. Were the standing charge to be very high relative to the competitive part of the tariff, there may not be enough variation in prices to induce switching (given that it appears to take a substantial price differential to activate consumers).

Ofgem's proposals to include social and environmental charges in the fixed element of the tariff will have regressive effects. The charges for these social and environmental obligations will be levied equally on high and low income consumers, in effect as a fixed tax per household which will be a higher proportion of the income of the poor than of the rich. This effect would be partially (but not completely) ameliorated if such charges were collected instead from the energy charge. High income households would pay a greater amount (because consumption and expenditure rise with income) but this would still be a lower proportion of their income (because energy expenditure increases less than proportionately to income). The most appropriate way to collect such charges, which reflect social or environmental rather than specific energy concerns, is the tax system, which can relate the levy directly to income; this would also have the merit of enabling consistency across utilities. However if Ofgem is constrained to collect such charges from energy consumers, doing so through the energy charge would be less regressive than via the fixed charge.

Moreover to the extent that environmental charges are imposed to reflect the difference between the social and private costs of energy (for example if carbon costs are inadequately included), adding them to fixed rather than energy costs would be perverse. Such charges should be part of the energy element to incentivise lower consumption if they are designed to reflect energy related costs.

A further concern is that the evergreen tariff will become the switch part of a dynamic bait-and-switch strategy where the regulator provides the credibility of the "switch" part as a good deal. There is almost no downside to firms of making the evergreen tariff the worst deal they offer; if consumers complain, the firm can always offer them a better deal, and since the tariff is one which they can present as "imposed by the regulator" it is not really their "fault" that it is such a bad deal, so the risk that consumers go directly to a competitor is likely relatively limited.

4. **Comparability of tariffs**

Ofgem proposes a single default tariff per payment method per region per provider (3 payment methods). These are to consist of the fixed component, set by the regulator (the same for all suppliers in any region) plus a per unit price which can be compared "at a glance". The consultation assumes that easier comparison and switching will lead to more engagement and savings for consumers. However, much depends on how the at-a-glance comparisons are implemented, particularly for the 75% of consumers who are currently on default tariffs . The consultation is not explicit about how this 'glance' would be activated. How much work would people have to do to get this information, and how they would see it?Would it be translated into the form of what they actually paid over the past 12 months compared with what they would have paid on the tariffs with which they are being invited to compare? Or would it be projected over the next 12 months on the basis of current rates? What would be the form of information best suited to help consumers make a robust judgment about whether to stick or switch? And how is this brought to the attention of consumers in conjunction with the means to switch if they wish to do so with minimum effort? Most people who go on to a default tariff will not "glance"[2] unless the comparative information is a) in the right/salient form, b) is put right in front of them, and c) is immediately linked to a simple way of acting on the information. Companies are likely to continue their current strategies of using fixed-term deals as 'bait' and then use the automatic transfer to the default to effectively put consumers on a worse deal after the fixed period.

Given consumer responses, more understanding is needed to ensure that "at a glance" involves minimum effort to make the salient comparisons, combined with minimum effort to switch. By focusing the information just on the defaults, this could induce competition between defaults, which is what is needed to prevent them being the vehicle for large margins. If there is more vigorous competition between defaults that drives down prices on those products, the incentive to proliferate even better fixed-term deals will be reduced, but this would reduce obfuscation and might leave the majority better off.

5. **Encouraging switching**

One relatively simple arrangement would be to insist on bills having something like the following format:

- During the past 12 months, the power you (were estimated to have) used cost you £650.
- If you had bought that amount on the best tariff your **current supplier** offered, it would have cost you £550 – you could have got it for £100 less
- (Alternatively, if they WERE on the best tariff, substitute: This was the best tariff your current supplier offered – with this supplier you could not have got your power for less.)
- If you had bought that amount on the best tariff a **different supplier** offered, you could have got it for £480 – with a different supplier you could have got it for £170 less.
- (Alternatively, if they WERE on the best tariff, substitute: This was the best fall-back tariff ANY supplier offered – over the last 12 months you could not have got your power for less with any other fall-back tariff.)
- If you would like help switching to a different fall-back tariff, call 0800 . . . or go to switchmeplease.org.uk or . . .

Note that the above information is reported in terms of the lump-sum bill (and savings) rather than in terms of kW/h, reflecting the marketing practice of companies. The presentation of any pricing information is likely to be very important in making the comparisons salient to consumers.

Even then, there might still be many people who intend to call or visit a site, but don't get around to it. So is there some agency other than the companies who could have an interest and an incentive in getting people to switch? After all, if there really **are** gains to be made by individuals who switch on a well-informed basis, and if the costs of switching are typically less than those gains for enough cases, then an agency which facilitates such switching should be able to cover its costs in some way.

Having a private company, or companies, do this might in principle be a possibility, but in practice, as the price-comparison-site experience has shown, there may be problems about the impartiality of

[2] Our recent research suggests that more than 10% of those who self-identified as "responsible" for their households electricity supply had not looked at a bill/statement of expenditure in the last year.

such sites, lack of trust by consumers, imperfect competition between such companies, and the potential problem that if they are too good at their job and stimulate too much competition, their own profits could be eroded and they might go out of business. (**Question 7**)

One possibility is that a section of Ofgem obtains copies of bills in electronic form with the key data above in such a format that an automatic screening program picks up some percentage of customers who could make the biggest (absolute or relative) savings by switching, and then calls these people to offer help switching them if they wish to do so. While this and other regulatory encouragement may seem very interventionist, the proposals in the RMR are themselves drastic in determining both the format of company tariffs and fixing the absolute level to be charged in the fixed rate per consumer.

Another potential agent is a charity or other trusted not-for-profit organisation(s). Each household that switches would agree to donate some percentage of its next year's savings to the charity that has effected the switch. This would require an extra line or two to be added to the annual bill summary of the form:

- "If you had bought that amount on the tariff you were on last year, it would have cost you £780 – so by switching you reduced the cost by £130. Of this, you agreed to donate 20% to Help The Aged (or whoever), so we will send £26 to that charity. Your total saving, after that donation has been passed on, is £104."

Such a deduction is a one-off (i.e. only relates to the first year's saving); for that charity (or any other) to benefit again, a fresh switch would be required the following year. The charity cannot 'milk' the difference between the old tariff and the new tariff for more than one year.

The advantage of this type of approach is that there is no payment if no gain has been achieved. And the payment, when it comes, is bundled with the information about the savings made, thereby going some way towards integrating gains and losses – the 'pain' of the 'loss' of paying the cost of switching is reduced by accounting for it mentally as linked to the gain – and any such pain is also reduced by the 'warm glow' of making a charitable contribution.

Charities would then need to encourage people to let them help them switch - if people can provide access to their bill statements with the key data given and are willing to let the charity do the switching work, this may help keep the costs down.

Finally, this proposal raises some interesting questions about how far consumers should be cajoled/forced to be active. An alternative argument might be that it would be better for the regulator to be more active. Preliminary results from the latest survey conducted by CCP (on searching and switching behaviour and its determinants in electricity markets) seems to show that the correlation for switching across markets (such as electricity, telecoms, financial products) depends on consumer characteristics rather than the experience of switching. If there are no spillovers from encouraging switching in one market, this removes an argument against a more regulatory solution. Might alternative direct protection of some consumers (e.g. by buying on their behalf) provide both more effective protection and the possibility of moving to a more active market at a later stage, rather than restricting offers and calcifying tariffs?

6. Concluding comments

It is unclear that companies will have an incentive to compete on their evergreen products, as mostly "sticky" consumers are likely to use these products (i.e. these consumers may be those who never switched to a fixed-term product, or those who switched once but for whom the prompt at the end of the fixed-term product did not encourage a further change). In addition, simply providing these disengaged consumers with more readily comparable information will not necessarily overcome the status quo bias and encourage them to become active market participants; nevertheless every effort should be made to give all consumers the key items of information in the most salient form, and research to establish the nature and form of this information should be a priority). On the other hand, it is likely that companies will have an incentive to compete for "reactive" consumers in the hope that they will not switch pro-actively at the end of the fixed term period. This could lead to better outcomes in the short-run for these consumers, as well as encouraging competition in fixed-term products.

Given the scale and extent of Ofgem's proposals, we urge them to undertake field experiments with different types of intervention before committing to universal changes. The behaviour of real consumers, surrounded by the distractions of real life, differs fundamentally and systematically from that reported in laboratories, focus groups or in response to questionnaires. Before intervening too radically, Ofgem needs to understand more about consumer reactions in the field, and our own response has suggested some possible actions, from direct protection for some consumers through intermediary action, to experimenting with private charitable intermediaries. However the effectiveness of any of these remedies will be limited if the underlying problem is lack of rivalry between the suppliers. No amount of consumer activity can be effective, individually or collectively, if entry barriers enable the current 'big 6' to charge high prices across consumer groups. If some form of collective dominance is the real problem, more drastic action, probably affecting the structure of the industry (as well as the behaviour remedies outlined here) will be necessary.