Tariff standardisation and restrictions

A REPORT PREPARED FOR ENERGY RETAIL ASSOCIATION

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Executive Summary

Frontier Economics has been commissioned by the Energy Retail Association to provide an independent review of Ofgem's proposals to improve tariff comparability, announced as part of its Retail Market Review (RMR).[1]

Following a four month review, Ofgem is proposing quite radical interventions to address its concern that complexity of pricing information is leading to consumer confusion and disengagement. We do not consider that the evidence Ofgem has presented justifies the proposed interventions. Further, we believe Ofgem's remedies will result in a number of unintended consequences that will impose costs and create distortions that will cause greater harm to consumers. We therefore put forward some alternative remedies that could support customers in making an effective choice, without limiting their choice.

Ofgem's proposed remedies

The proposed remedies that Ofgem has put forward as part of the RMR are to:

- restrict the number of evergreen tariffs that a supplier can offer to one per payment method;
- restrict the form of the evergreen tariff, with Ofgem setting a "compulsory standard element" and suppliers then required to compete on the basis of a single national unit charge;
- prohibit automatic roll-over for fixed-term products, with customers being moved to the standard evergreen tariff unless they actively sign-up for an alternative; and
- require that all tariffs are presented for comparison purposes on an "evergreen equivalent" format.

To justify such intervention, Ofgem must demonstrate that consumers find tariff information complex, that this results in a lack of engagement or poor switching decisions and, most importantly, that this has led to adverse outcomes in the retail market.

- Ofgem presents evidence that shows that some customers are confused. However, we believe it has overstated the extent of this confusion and failed to provide sufficient clarity about what the underlying drivers of this confusion are (which is an important precursor to the design of any remedy).
- The evidence to suggest that this confusion is causing customers to disengage from the market is not persuasive. Ofgem has not adequately evaluated

1 "The Retail Market Review – Findings and initial proposals", Ofgem (March 2011).

whether any lack of activity on the part of customers is due disengagement or is based on informed choice (because customers have made a rational decision not to change supplier as they are happy and/or do not consider the achievable savings are sufficient to warrant change).

- Further, Ofgem has not made the case that this confusion and associated disengagement has led to an adverse impact on market outcomes since margins are low, switching is high and there is no evidence that confusion is acting as a barrier to entry.

Assessment of proposed remedies

As well as questioning the evidence base for intervention, we also consider that Ofgem has not properly evaluated the likely impact of its remedies outside of the narrow objective of improving tariff comparability. We believe that Ofgem's current set of proposals are likely to cause more problems than they solve. Since some of its proposals seek to restrict choice, while others will dictate the choices that customers make, they will have an impact far wider than the specific problem Ofgem is seeking to address. As highlighted by the Office of Fair Trading (OFT) in its work on behavioural economics, poorly designed consumer policy can impose costs and create distortions that harm customers.

Any market intervention must therefore be assessed not only from the perspective of whether it can be expected to address the problem it is intended to remedy, but also whether it could have wider market impacts. Given this, we have the following significant concerns about Ofgem's proposed remedies.

- **Restriction of evergreen tariffs:** The present range of evergreen tariffs allows suppliers to attach specific features to their products that customers value. This remedy will remove these features.
  - **Risk of customer disengagement:** This policy involves removing customers from tariffs that they have often actively chosen. To retain the features of their tariffs customers would have to change to a different type of product (potentially with exit fees). Consequently, there is a risk that customers would become more confused and further disengaged. This confusion would be widespread given the number of customers on these types of tariffs. Customers would also suffer a degree of inconvenience in having to make a change, and face a potential loss if they fail to do so.
  - **Restriction of choice:** Ofgem's claim that its policy does not restrict choice rests on the assumption that customers see evergreen and fixed-term products as close substitutes. This is unlikely to be the case. Because fixed term products cannot contain unilateral contract variation terms, prices must be fixed (with exit penalties) or linked to an index. This will make 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 involves effort.

- **Impact on competition:** The evergreen tariff may become seen as a "regulated" tariff by customers. As such, customers may be inclined to stay on it, rather than search out and switch to more suitable tariffs. It may also reduce entry, to the extent that new entrants could have based their business model on meeting the demand of the subset of customers that are looking for simplicity ahead of other product characteristics.

- **Restrictions on the form of evergreen tariffs:** As currently proposed, Ofgem's proposed fixed charge will not cover all supply business fixed costs. These additional fixed costs will have to be recovered from the variable charge. This will introduce a cross-subsidy between large and small customers and increase supplier risk. The practical implementation of the standardised element will also be more complicated than Ofgem's proposal suggests, and could lead suppliers to change price at the same point in the year. It also marks a return to price regulation as the rest of Europe moves to liberalise their retail markets.

- **Prohibition of the automatic roll-over:** Some customers do not want to sign up to a product that requires them to take regular action to stay on it. It will also weaken incentives for customers to search for better deals, and for suppliers to seek to offer them. This has been a big driver of competition that has benefits for non-switchers as well as switchers.

- **Prescription of standard comparisons:** The standardisation will be misleading, since it will omit important product information. This could lead to customers making poor decisions. Further, smart meters and more sophisticated TOU tariffs will render unit price comparisons based on average consumption even more meaningless and could put at risk the Government's case for smart metering if it leads to a lower take up rate of these tariffs. Such comparisons could also create an undue focus on price competition at the expense of competition on other dimensions of service.

It is also instructive to look at whether Ofgem's remedies are proportionate to those applied in other cases where customer confusion has been identified as an issue. As we examine later in this report, the remedies have focussed on the provision of information or measures to improve switching in other similar cases. Options that constrained customer choice, for example by limiting offers, have rarely been imposed. Other lessons that can be learnt from similar cases include the following.

- **Take care when standardising comparisons:** Other bodies have taken account of the risk of losing important information when standardising quotations. Standardisation is not imposed if there is a risk that it could reduce product innovation or the incentive to meet different customer needs.

- **Help customers to make better choices:** Policies to educate and help customers make better choices are preferred to those that can limit choice or rely on over-simplified comparisons.

- **Do not unnecessarily constrain competitive behaviour:** Consumers are aware of pricing structures such as those associated with introductory offers. Banning these offers, or requiring customers to be moved to better tariffs at the end of fixed periods, removes an important incentive for customers to search out the best offers to switch.

- **Take account of customer inconvenience associated with policy intervention:** The benefit of any remedy should outweigh the cost of any associated loss of customer convenience.

Alternative remedies

Ofgem has raised concerns that consumer confusion may have led to a lack of engagement or trust with the industry. If this is the case, policies that reduce confusion so that more customers can play an active role in the energy retail market may be justified.

However, given the evidence base that Ofgem has developed, the primary objective of intervention should be to support customers in making an effective choice, without limiting their choice. Indeed, limiting choice to deal with consumer confusion should be a last resort and only introduced if there is compelling evidence of both:

- a significant harm associated with customer confusion that is a direct result of the choice on offer; and
- an absence of any other policy that could address the concern at lower expected cost.

We do not believe that either of these tests has been met. Therefore we do not believe that a remedy should be introduced if it will restrict product choice or undermine incentives to search the market and switch. This includes limiting the number of evergreen products and abolishing the automatic roll-over for fixed-term products.

We also believe that before Ofgem introduces any new policies, it should do two things.

- Further research should be done to understand the appropriateness, and potential unintended consequences, of any remedy before it is imposed. For example, how will customers react to being removed from evergreen tariff offers that they have chosen?

- A more holistic view of the policy landscape should be taken before implementing further change. This means working with Government to avoid multiple proposals aimed at addressing the same overall objectives. It also requires looking at how interventions would be expected to fit with the direction of future energy policy, particularly given the introduction of smart metering and the requirement for customer engagement to deliver energy efficiency targets. There is a danger that no one is taking a long-term view of what the sector needs and, as a result, there is a risk of inconsistent and complex policy measures contributing to further customer confusion.

With these caveats in mind, we propose some options for remedies to address the concerns about customer confusion that may merit further consideration.

- **Optimise existing policies first:** There is a strong case for allowing time for the Probe remedies to bed down and be developed to their potential before seeing if further action is required. This is not least because the Probe remedy of an annual energy statement would seem to be exactly the sort of intervention that could be expected to help customers. The recently announced entry of Co-Operative Energy, with its single unit evergreen tariff penalty-free offering, should also be given a chance to develop. It would certainly be unfortunate if Ofgem's policy intervention potentially compromised the first large-scale entrant into the domestic energy retail market in recent years. Further, smart meters will act as a catalyst for change. Using these as part of the policy solution is vital.

- **More help with comparisons:** Rather than providing simple (yet misleading) comparisons, make use of the fact that technology can provide customers with accurate comparisons. This should be possible with a requirement to provide customers with their own consumption information and the availability of trusted comparison services accessible to all consumers. Smart meters should also help in the longer term as they will provide accurate consumption data and up to date information about energy costs.

- **Simplification of information:** Perhaps one of the easiest wins is to encourage (or enforce) the use of a common set of language to be used by suppliers when communicating with customers about tariffs and energy bills. This will be expected to increase customer understanding and should also make it easier to educate customers about their energy use and bills.

- **Improved notification of options at the end of a fixed-term period:** Customers should be clearly notified of their options for alternative tariffs at the end of the fixed-term period.

- **Education:** The ideal would be to educate customers about their energy use so that they are better able to engage in the market. Consumers have scope for learning. There is a danger that in trying to over-simplify the problem to customers you may actually reduce their ability to engage. This is particularly pertinent given the need to engage customers in further (potentially complex) offerings as part of the Green Deal and smart industry roll-out.

- **Switching:** Policies aimed at making switching easier, or even making customers realise that the switching process is not as difficult as they may have thought, are likely to have benefits. One reason why customers may not switch is because they fear making the wrong choice. It is therefore worth considering whether suppliers could do more to check that a customer wants the tariff that he has signed up for.

- **Social policy:** Trying to protect customers that are truly vulnerable is better delivered through measures aimed specifically at them (for example through the Warm Home Discount scheme). This is likely to be more effective than weakening competition and penalising those that would otherwise have benefited from competition.

1 Introduction

Frontier Economics has been commissioned by the Energy Retail Association to provide an independent review of Ofgem's proposals to improve tariff comparability, announced as part of its Retail Market Review (RMR).[2] This report evaluates these proposals and puts forward an alternative set of remedies that we believe would better meet the identified concerns.

Ofgem's latest RMR follows its detailed 2008 Energy Supply Probe[3]. A number of the remedies introduced as a result of that investigation have only recently been implemented and so have had inadequate time to bed down. Following a four month review, Ofgem is proposing some significant market interventions to address what it believes to be a growing complexity of pricing information that is leading to consumer confusion and disengagement.

Although Ofgem has put forward some quite radical proposed remedies, it has failed to properly consider their likely impact outside of the narrow objective of improving tariff comparability. Since some of its proposals seek to restrict choice, while others will dictate the choices that customers make, they will have an impact far wider than the specific issue that Ofgem is seeking to address. As the Office of Fair Trading (OFT) cautions in its consideration of behavioural economics, "markets can be self-correcting and interventions can potentially do more harm than good"[4].

While we agree that some consumers do appear to find engaging with the energy retail market difficult, we strongly believe that any remedy should not constrain customer choice or hinder competition. We therefore put forward an alternative set of proposals that are more proportionate the problems identified and may be expected to have fewer unforeseen consequences.

Our report is structured as follows.

- Section 2 looks at Ofgem's proposals, breaking them down into their constituent parts. We look at the case for intervention, to evaluate whether Ofgem has demonstrated its case that consumers are confused, that this confusion has led to disengagement, and that the disengagement has led to evidence of harm.

- Section 3 looks at the unintended consequences that may be expected to result from the interventions Ofgem has proposed. It also questions whether

2 "The Retail Market Review – Findings and initial proposals", Ofgem (March 2011).

3 "Energy Supply Probe – Initial findings report", Ofgem (October 2008).

4 "What does Behavioural Economics mean for Competition Policy?", OFT (March 2010), p. 30.

Ofgem's response is proportionate to the evidence presented, based on precedent from other regulators and competition authorities.

- Section 4 puts forward an alternative set of proposals that would better meet the identified concerns by supporting consumers in making effective choices, without limiting their choice.

2 Ofgem's proposed remedies

In this section, we look at the policies to improve tariff comparability that Ofgem has put forward as part of Proposal 1 of its RMR. To better understand the intent of these proposals and their appropriateness, we go on to review the case for intervention. This looks both at the economic rationale for intervention, as well as the evidence Ofgem presents to justify action at this time.

2.1 Ofgem's proposals

Ofgem's stated aim of Proposal 1 of its RMR is to "make it far easier for domestic consumers to compare prices and choose a better deal"[5]. To achieve this it has put forward a policy package that has four main elements.

- **Restrict the number of evergreen products:** Ofgem proposes to limit the number of tariffs for standard evergreen products a company can offer to just three: one for each major payment method. Suppliers will still be free to offer an unrestricted number of fixed-term products. However, fixed term products have some very different features to evergreen products, notably that they must be of limited duration and are not allowed to contain "adverse unilateral variations" (which means prices must be fixed or linked to an index that customers are able to understand). Because of these differences, Ofgem's policy can be expected to restrict customer choice.

- **Restrict the form of the evergreen tariffs:** Ofgem is proposing to restrict the form that the evergreen tariffs can take. There are two restrictions.

  - Ofgem will set a "compulsory standard element" that will need to be identified separately on a bill and will therefore function effectively as a standing charge. This will be the same for all customers in each region.

  - It will then require the suppliers to recover all other revenue from a single unit charge that will have to be the same rate nationally. All price competition between suppliers will therefore be constrained to take place only on this standard unit rate.

- **Prohibit automatic roll-over:** For all fixed-term products, Ofgem will require the default to be that a customer is put on to the evergreen tariff when the fixed term comes to an end, unless he actively signs up for an alternative tariff.

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5 Ofgem (March 2011), p. 7.

- **Prescript standard comparisons:** Ofgem has also proposed that all fixed-term products are presented for comparison purposes on an "evergreen equivalent" format. Ofgem has suggested that this could be done by subtracting the annual cost of the relevant standardised element for a consumer in a particular region from the annual estimated bill of the fixed term contract. The residual could then be presented on a p/kWh format to compare with the price of the evergreen contracts.

Ofgem has said that these measures are intended to achieve three objectives[6].

- **Reduce the complexity of tariff offerings:** This would be through the restrictions in the form of the evergreen tariff.

- **Improve comparability of tariff offerings:** This is covered both by the standardisation of the evergreen contracts and by dictating that all tariffs are presented in a standard format.

- **Decrease the number of standard evergreen products available:** This is clearly achieved by Ofgem's policy of enforcing a restriction in tariff numbers. We assume that Ofgem sees limiting these tariffs as helping to aid comparability by reducing the number of tariffs that consumers have to choose between (assuming that they see evergreen tariffs as different products to fixed-term ones). We also assume that Ofgem sees a benefit to pushing consumers onto fixed-term products as this will provide an opportunity for them to engage in the market every time their fixed-term deal ends.

As well as looking at the new proposals that Ofgem has put forward as part of the RMR, it is also important to look at the proposals it made following the Probe that could also be expected to impact on these objectives.

- **Requirement for an Annual Statement:** Since July 2010 all gas and electricity providers are required to send every customer an annual statement with information about their energy use and how to switch supplier.[7] As Ofgem acknowledges in a footnote in the RMR, this means that not all customers will have received this statement until the end of June 2011.[8] The annual statement needs to contain the following information:
  - the customer's exact tariff name;

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6 Ofgem (March 2011), para. 3.14.

7 Standard Licence Condition (SLC) 31A.

8 Ofgem (March 2011), fn. 28.

- specific principal terms of the customer's existing contract;
- consumption for the last 12 months in kilowatt hours (except where a customer has been with the supplier for less than 12 months);
- an illustrative projected cost in pounds per year of the supply for the following 12 months if the same level of consumption was used at current prices;
- details of any premium or discount that applies to the customer's tariff as compared to the supplier's standard monthly direct debit tariff;
- a reminder in a prominent position that customers can switch supplier; and
- signposting to sources of independent switching advice.[9]

Ofgem notes that the implementation has varied between suppliers and that improvements can be made to achieve the objectives of the measure.[10] This is something that it is considering under Proposal 3 of its RMR remedies.

- **Prohibition of undue discrimination in supply:** The introduction of this condition limited the scope for suppliers to vary their evergreen tariffs. It therefore has had a similar effect to Ofgem's current proposals in that it moved competition away from enduring offers on evergreen contracts towards fixed-term promotional discounts. In doing so, it may also have weakened competition.[11]

As well as policy intervention by Ofgem in this area, Government has also been involved through the coalition proposal for customer bills to contain information on how customers can move to their supplier's cheapest tariff. DECC has been consulting on how to implement this policy, given difficulties in determining what the "cheapest" tariff for any customer will be as it would depend on factors such as the payment method and whether the customer would be prepared to accept restrictions such as an on-line only account.[12]

Ofgem's interventions also need to be seen in terms of the wider policy agenda.

- The Government mandate for smart meters means that increasing numbers of customers will be getting this technology over the coming years. This will

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9 "Energy supply probe – proposed retail market remedies", Ofgem (2009).

10 Ofgem (March 2011), para. 2.19.

11 A recent paper concluded that "the most likely effect of the Licence condition is to reduce competition in the mainstream energy markets", "Non-discrimination clauses in the retail energy sector", Morten Hviid and Catherine Waddams Price, CCP Working Paper 10-18 (November 2010).

12 "Energy Bill – Green Deal Impact Assessment", DECC (December 2010), p. 71-76.

provide a whole new way for suppliers to communicate with their customers about their energy supply. Further, the Impact Assessment that supports this policy requires that a number of customers take up the more complex Time of Use tariffs that these meters support.

- The Green Deal[13] is also about to be launched where customers will need to understand how investment in energy efficiency measures will essentially be financed via deductions from energy bills over time.

Both policies will require increasing customer understanding about energy costs and should be supported by a national programme of customer education.

There is a danger that no one is taking a long-term view of what the sector needs and, as a result, there is a risk of inconsistent and complex policy measures contributing to further customer confusion.

2.2 Evidence base for intervention

Ofgem justifies its proposals for intervention in the energy retail market by drawing on a behavioural economics framework.[14,15] In summary, it is based on the following reasoning.

- Consumers exhibit systematic behavioural biases[16] that affect their ability to access, assess and act on information to make decisions. These behavioural biases are general characteristics of consumer behaviour and may affect consumers' decision-making in a wide range of markets.
- Market features, such as complex pricing information and lack of comparability of pricing information, can increase the impact of these biases. Ofgem considers that the energy markets have these features. This may manifest itself in consumers abandoning their search for better products or in making poor switching decisions.
- The inherent biases, compounded by the complex information, mean that Ofgem considers that many consumers disengage from the market or make

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13 Under the Green Deal, private companies will offer consumers energy efficiency improvements worth up to £6,500 at no upfront cost, and recoup payments through a charge in instalments on the energy bill.

14 Behavioural economics combines traditional economic models with psychological concepts to help to better understand consumer behaviour.

15 Ofgem (March 2011), para. 2.8.-2.9. and "What can behavioural economics say about GB energy consumers?", Ofgem (2011).

16 Ofgem has looked at four biases: limited consumer capacity, status quo bias, loss aversion and time inconsistency.

poor switching decisions.[17] It considers that this has led to both direct consumer harm (by adversely affecting prices or service quality directly) and indirect consumer harm (since a lack of effective consumer engagement weakens the intensity of competition among suppliers).

Ofgem notes that the effect of behavioural biases may be different for different consumers.[18] It refers to a paper by the Communications Consumer Panel, which finds that the evidence from behavioural economics shows that some vulnerable groups are more likely to exhibit behavioural biases.[19] However, it is worth noting that the Panel points out that its conclusions are preliminary as the area of individual difference in behaviour is not well researched and existing evidence is not as robust as the core branches of behavioural economics.[20]

Ofgem needs to provide robust and consistent evidence to support its theory of harm and justify its RMR proposals to make such radical interventions into the market.

- It must show that consumers find tariff information in energy markets sufficiently complex to cause them problems. Further, it should be clear about what it is that is confusing consumers since the optimal policy response may be very different depending on how consumer ability is impaired.
- It must then show that this confusion has resulted in a lack of engagement by consumers in energy markets, and that any reduction in engagement has not been caused by other factors such as a reduction in the expected benefit from switching or an increase in customer satisfaction.
- Finally, and most importantly, it must show that complexity and lack of engagement have led to adverse outcomes in the energy markets.

We look at each of these in turn.

2.2.1 Complexity of tariff information

Ofgem puts forward two main pieces of evidence to support the concern that tariff information may be causing consumer confusion: survey evidence of confusion and information about the number of available tariffs.

17 Ofgem (March 2011), para. 2.3.

18 Ofgem (March 2011), para. 2.8-2.12. and 4.6.

19 "What can behavioural economics say about GB energy consumers?", Ofgem (March 2011), para. 4.6.

20 "Behavioural economics and 'vulnerable consumers': A summary of evidence", Communications Consumer Panel (December 2010), p. 2.

Survey evidence

Ofgem refers to several pieces of consumer research that suggest some consumers get confused when trying to understand energy tariffs. However, we have two issues with the presentation of this evidence. First, Ofgem appears to have exaggerated the extent of this confusion. Second, the evidence is weaker about what is driving the confusion. This is extremely important because without a better understanding of what causes the confusion, it is not possible to design appropriate and targeted remedies.

Turning to the first of these issues, Ofgem often presents its evidence in a way that suggests a greater degree of confusion than may be the case.

For example, Ofgem states that "research by the OFT suggests that complex pricing is more prevalent in energy retail than in many other sectors".[21] However, the wording of the underlying survey question is somewhat leading as the question prompt suggests "gas and electricity supply" as an option.[22] This may have biased the responses. Further, Ofgem quotes that 75% of the customers *that experienced complex pricing in the energy sector* objected to the way in which electricity and gas prices are presented.[23] However, it is not surprising that a very high proportion of respondents answered "object" when asked how they feel about price offers that they have already said are "complicated and difficult to compare."[24] It fails to take account the views of those customers that did not feel that they had experienced complex pricing, who may also not object to the way prices are presented.

While Ofgem's evidence shows that some consumers are confused, it is worth noting that Ofgem's research has also shown that there is a group of consumers that value choice in the number and range of tariffs available.[25] The summary of the panel discussion reports that "a few more proactive and engaged Panellists said that a choice of tariff enabled some consumers to pick the tariff that best suited their individual life circumstances and energy behaviour (i.e. single versus large person families)."[26]

A recent EU study into electricity retail markets in Europe also concludes that "consumers value a wide choice of tariffs and suppliers and a positive link

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21 Ofgem (March 2011), p. 20.

22 "[…] Have you seen a price offer which was complicated or difficult to compare with other prices, which might include mobile phone tariffs, TV packages, insurance or prices for gas or electricity supply?", see "Advertising of prices - Annexe M", OFT (December 2010), QS1 C.

23 Ofgem (March 2011), p. 20.

24 "Advertising of prices - Annexe M", OFT (December 2010), QC1-QC3.

25 Ofgem (March 2011), Appendix 6, para. 1.51.

26 "Ofgem consumer first panel year 3", Ofgem (2011), p. 20.

appears to exist between the extent to which consumers believe that their supplier offers a sufficient choice of tariffs and the extent to which consumers are satisfied with services and tariffs provided by their supplier. In addition, consumers tend to be more satisfied if there is a large variety of tariffs, suppliers and contract types."[27]

These findings show that there is a range of customer attitudes towards suppliers' tariff policies. It could also indicate that although consumers raise concerns about the problems associated with having multiple tariffs to choose between, they may complain more if this choice was taken away.

Turning to the second point, it is not clear what is driving the confusion that customers are experiencing. For example, is it:

- the form of tariffs?
- the terminology?
- the fact it is "energy" and therefore, by definition, is perceived as being difficult?
- a lack of consumer interest?
- the way comparisons are presented?
- the number of tariffs?[28]

The OFT asked those customers who had found it difficult to choose an energy supplier why this was the case. The answer that "40 per cent thought the market was too confusing and complicated"[29], is not particularly informative. The other reasons cited included factors such as the number of options available, different terms suppliers use and difficulties to calculate the amount due over the contract period.

Overall we feel that more could be done to understand the causes of consumer confusion. Since the optimal policy response may be very different depending on how consumer ability is impaired, it is hard to design appropriate remedies without this understanding.[30]

27 "The functioning of retail electricity markets for consumers in the European Union – Final report", ECME Consortium (November 2010), p. viii.

28 This list is not intended to be exhaustive.

29 Ofgem (March 2011), p. 20.

30 See, for example, "Gain or pain: Does consumer activity reflect utility maximisation?", Chang, Waddams Price (February 2008), p. 3.

Number of tariffs

Ofgem attributes one source of confusion to the large and increasing number of tariffs that customers face and it provides a statistic that shows the increase in the number of energy tariffs since 2007. We would make the following observations about this evidence.

- When trying to understand what is causing customer confusion, the absolute number of tariffs is less important than the number of tariffs that customers actually see when they wish to make a decision about changing supplier. We have not been able to replicate Ofgem's analysis, but suspect that a large number of the tariffs that they report are old versions of tariffs that would not appear in customer searches. It is not clear these add to consumer confusion.

- For its recent study on European electricity retail markets, the European Commission undertook a price collection exercise in different countries. The results do not support the view that the number of electricity tariffs available in the UK is particularly high.[31] Further it presents evidence that the number of tariffs on offer increases with the maturity of liberalised markets as a result of new entry and innovation.[32]

- Any recent increase in the number of tariffs may be largely driven by an increase in time limited promotional products that are likely to have been driven by Ofgem's intervention in the market to prohibit non-discrimination (SLC 25A) that followed its Probe.

In summary, although there is a concern that some consumers are confused by their energy tariffs and usage, we feel that the extent of this confusion may have been overplayed, and there is insufficient clarity about the source of this confusion.

2.2.2 Lack of consumer engagement

To support the introduction of its interventionist remedies, Ofgem next needs to show that not only do customers find energy offers confusing, but that this confusion leads them to disengage from the market. To do this Ofgem relies heavily on conclusions it draws from looking at the level, and trends, in the number of customers that are switching supplier.

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31 "The functioning of retail electricity markets for consumer in the European Union", ECME Consortium (November 2010), ch. 2 (Table 2, p. 32).

32 ECME Consortium (November 2010), p.29.

Ofgem sees a recent decline in switching rates as important evidence of increasing customer disengagement. However, the fall itself is not large[33] and there are other credible explanations for this fall. One such explanation is that the benefits from switching supplier may have been reduced as a result of Ofgem's Probe remedies. In particular, the benefit to switching may be lower following the introduction of non-discrimination provision. If customers do not see the benefit as being sufficient to outweigh the cost (in time and effort) then they will not bother to switch.

Another explanation is that customers are happy with their suppliers. Ofgem seems to discount the fact that customers may have not switched for quite rational reasons, rather than as a result of behavioural biases. Indeed, 77% of customers that say they are happy having never switched supplier[34]. Another reason that consumers named for not switching is that they checked price and found that they were on a good deal. These results are supported by the European Commission's consumer research which shows that the most common reason why electricity consumers in the UK do not try to switch supplier is that they are satisfied (41%)[35].

It is also the case that switching levels are still high compared with other industries. In its initial findings report on the Probe, Ofgem presented consumer research that had found that "with the exception of the car insurance market more gas and electricity consumers have switched their supplier than in any other major consumer services sector in GB over the past five years - many of which have had a far longer history of customer choice."[36] Further they are high compared with switching rates in other countries: the UK supplier switching rate is the second highest in Europe.[37]

We do not therefore accept Ofgem's view that the level of switching seen in the energy sector is evidence of a large number of disengaged customers. In fact, we think the evidence shows quite the contrary. Indeed, if Ofgem's approach was applied consistently, then we would be looking at advocating wide-scale market intervention across many industries in GB.

2.2.3 Impact on market outcomes

As well as needing to demonstrate that consumer confusion leads to disengagement, Ofgem must also show that this creates an adverse impact that

33 DUKES, Table 2.7.1 (31st March 2011).

34 Ofgem (March 2011), p. 30.

35 ECME Consortium (November 2010), 3.3.

36 "Energy supply probe – initial findings report", Ofgem (2008), p. 46.

37 ECME (November 2010), 3.2.1.

can be observed in market outcomes. There are a number of indicators that could be used to establish whether this is the case.

- **Margins:** Ofgem's analysis[38] indicates that margins are a "stationary series", that is, they do not trend up or down over time. Consequently, the evidence presented by Ofgem does not suggest that suppliers are able to exploit customers' confusion and disengagement to earn ever increasing profits. Second, Ofgem's analysis also indicates that the margins themselves do not appear excessive in comparison to other industries.[39]

- **Service quality:** Ofgem does not present any evidence to suggest that the level of customer service is being cut, which, if it were true would have indicated that suppliers would have exploited customers' confusion and disengagement to cut service and thereby reduce customers' value for money.

- **Barriers to entry:** Ofgem does not investigate whether customer confusion and disengagement is having the effect of raising barriers to entry in the market, and we are not aware that any evidence has been found to show that this effect is occurring. In fact, the opposite may be true. At least one new entrant - Co-operative Energy - is using a competitive marketing strategy that targets consumers that are assumed to find the available price offers complex and may lack trust in the established energy suppliers. Its offer (called "Pioneer") is based on a simple single unit evergreen tariff.[40]

- **Switching rates:** As noted above, switching levels are high compared with other industries and other countries. This switching evidence corresponds to market shares which continue to fall for the incumbent suppliers in their respective areas, both across all customers and the more active dual-fuel customers. It is noticeable that in the latter group, the former incumbent electricity supplier is the largest supplier in only two regions

2.3 Summary

The evidence base that Ofgem presents does indicate that some customers may be confused, although the extent of this confusion may be overstated and it is not clear what the underlying drivers of this confusion are. Ofgem has also not demonstrated that any reduced activity on the part of customers is due to a lack

38 "Do energy bills respond faster to rising costs than falling costs?", Ofgem (2011).

39 Ofgem (March 2011), Appendix 9, para. 1.6. and Figure 2.

40 See the Co-operative energy website: www.cooperativeenergy.coop/good-with-energy/our-tariff/.

of engagement rather than because customers have made an informed choice. Finally, Ofgem does not present convincing evidence to support the proposition that this confusion, and associated disengagement, is adversely impacting on market outcomes.

3 Assessment of proposed remedies

Poorly designed consumer policy can impose costs and create distortions that harm customers. This is well recognised by regulatory and competition authorities, and has been a feature of the OFT's guidance on implementing remedies associated with insights from behavioural economics.

"First on a principled level, we want solutions that solve the problem, but we do not want to remove consumer choice…Second, there is no guarantee that authorities will necessarily improve the market or not create unforeseen consequences elsewhere. …In such situations an authority would be wise to be conscious of its own limitations"[41]

To assess Ofgem's proposed remedies for improving tariff comparability, it is useful to consider two questions.

- Are there unintended consequences that might outweigh the expected benefits of the proposals?
- Are the proposals proportionate and in line with other precedents?

3.1 Unintended consequences

Any market intervention must be assessed not only from the perspective of whether it can be expected to address the problem it is intended to remedy, but also whether it could have wider market impacts. For example, as we discussed in the previous section, interventions made by Ofgem following the Probe may have led to the increase in the number of tariffs and lower switching rates that are now the focus of its Retail Market Review.

In the light of this, we consider each element of Ofgem's Proposal 1:

- restriction on the number of evergreen products;
- restriction on the form of evergreen tariffs;
- prohibition of automatic roll-over; and
- prescription of standard comparisons.

3.1.1 Restriction on the number of evergreen products

Ofgem proposes to limit the number of standard evergreen products a company can offer to just three: one for each major payment method. This restriction will be expected to have a significant impact, since 75% of consumers are currently

41 "What does behavioural economics mean for competition policy?", OFT (March 2010), p. 34.

on these tariffs. We look at the following three potential adverse consequences of this remedy:

- risk of customer disengagement;
- restriction of choice; and
- impact on competition.

Risk of customer disengagement

The present range of evergreen tariffs allows suppliers to attach specific features to their products that customers might value, for example:

- time of use tariffs such as Economy 7, Economy 10 and the teleswitching tariffs that are common is some regions of the country, as well as additional Time of Use tariffs that may develop following the introduction of smart metering;
- tariffs that come with discounts or bonuses such as nectar points, charity payments, prompt-pay discounts and dual fuel discounts; and
- "optional" partner tariffs such as the Age UK tariff.

If the number of evergreen products is reduced to one per payment method, then these features of currently available evergreen products will no longer be available. This will have an immediate effect on customers as these features that they have chosen and value will be removed.

These attributes may then be re-introduced into particular fixed term contracts. However, customers may be confused and frustrated that they are being expected to sign-up to a new limited-term tariff to retain their choice. Some may not wish to sign-up to a fixed-term deal. And many will simply not notice that they have to take action and therefore be moved to a tariff that no longer has the benefits they value. Given the number of customers on these types of tariffs, widespread customer confusion could result. Also, customers could be made substantially worse off. For example, a customer on an Economy 7 tariff that is moved to a standard tariff will see bills rise substantially.

Consequently, there is a risk that customers will become more confused and further disengaged. They will also suffer a degree of inconvenience in having to make a change, and face a potential loss if they fail to do so.

Restriction of choice

Under Ofgem's proposals, suppliers are still able to offer an unrestricted number of non-standard tariffs, provided that these are for a set duration with fixed terms and conditions. Ofgem says that it is not restricting choice by limiting the number of evergreen tariffs as its proposals create "an active market for a diverse range of non-standard products". However, this assumes that customers do not value evergreen tariffs 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.

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.

Impact on competition

Ofgem has not evaluated the impact of its proposals on the development of competition in the market. There could be a number of effects that would result from the application of this remedy that fit into two broad categories.

First, the evergreen tariff will potentially become seen as a "regulated" tariff by customers. As such, customers may be inclined to stay on it, rather than search out and switch to more suitable tariffs. This could cause further disengagement from the market, with the result that customers fail to develop the skills associated with choosing the deal that is best for them and learning from the experience. This is particularly pertinent given the need to engage customers in further (potentially complex) offerings as part of the Green Deal and smart industry roll-out.

Second, it may reduce entry, to the extent that new entrants could have based their business model on meeting the demand of the subset of customers that are looking for simplicity ahead of other product characteristics. This certainly appears to be the proposed model of entry for Co-operative Energy, which is using a strategy that aims to target consumers that find price offers complex with a simple single unit evergreen tariff.[42]

42 "Co-op plans to be a big seven supplier", Utility Weekly (13 May 2011).

3.1.2 Restrictions on the form of evergreen tariffs

Ofgem is proposing to restrict the form that the evergreen tariffs can take. This is by fixing part of the tariff on a regional basis and then requiring suppliers to set a standard variable tariff on a national basis. There are a number of difficulties associated with such a proposal.

First, Ofgem's proposed fixed charge will not cover all of the fixed costs associated with the supply business. Other charges, such as supplier metering costs, will have a fixed element. These will be unique to each supplier. Ofgem's proposal will therefore mean that these fixed costs will have to be recovered from the variable charge. As a consequence, it will introduce a cross-subsidy between large and small customers. Further, if the pricing structure imposed on suppliers does not reflect the costs that they face this will also increase their risk: in particular, suppliers will want to avoid taking on a disproportionate number of small customers as they will not expect to recover the costs of supplying them.

Second, the practical implementation of the standardised element will also be more complicated than Ofgem's proposal suggests. For example, how do you take account of the charges made by independent networks? There are also likely to be timing problems given notification periods around changes to use of system charges. This may also push suppliers to change price at the same point in the year (as it will follow Ofgem's announcement of the standardised element). Suppliers changing price simultaneously was a concern that Ofgem raised as part of the Probe.

Finally, the proposals represent a significant retrograde step towards a return to price regulation in this sector, and are contrary to the positive moves being taken to promote competition in the energy retail sectors across Europe.

3.1.3 Prohibition of the automatic roll-over

The prohibition of the automatic roll-over raises two issues.

The first relates to the problem of inconvenience discussed earlier. If automatic roll-overs are abolished, then customers who have already expended effort to understand and sign up to a fixed term contract that meets their specific needs will have to do so again a year later or risk losing out on benefits that will not be available with the evergreen product. Some customers, quite rationally, do not want to sign up to a product that requires them to take regular action.

We accept that one of the advantages of customers moving from evergreen products to fixed-term ones is that it creates a future "event" to encourage switching. However, once on the fixed-term product, an event will still occur in the form of the prompt that customers will get when their fixed term contract is drawing to a close. The Annual Statement provides another such prompt. The value of the additional prompt associated with the abolition of the roll-over will therefore be low.

Second, this remedy could negatively impact switching behaviour. Ofgem seems to appreciate that it is reducing suppliers' ability to segment the market between switchers and non-switchers, but there is no sense that it has considered the longer term implications of this. The OFT was alive to this risk when it rejected a proposal to ban introductory bonus rates for cash ISAs as it "removes an important incentive for consumers to seek out the best deals and switch."[43] Ofgem's proposal carries the risk that it weakens incentives for customers to search for better deals, and for suppliers to seek to offer them. This has been a big driver of competition that has benefits for non-switchers as well as switchers. Further, it has a negative distributional impact on customers who are willing to search the market.

3.1.4 Prescription of standard comparisons

Ofgem's standardisation proposal condenses complex offers into an "evergreen equivalent" price metric based on average price per kWh at average consumption levels. The proposals for standardised comparisons across all tariffs can be expected to have two potentially adverse consequences:

- the standardisation may be misleading leading to poor decision-making; and
- it can create an undue focus on price competition at the expense of competition on other dimensions of service.

Misleading – leading to consumers making poor decisions

Ofgem believes that mandating suppliers to present all non-standard tariff offerings using an 'evergreen-equivalent' price metric "would mean that consumers could compare the prices of all tariffs in the marketplace with ease"[44] While Ofgem's proposals would lead to customers undertaking comparisons "with ease", the comparisons they would be undertaking would almost certainly be misleading. This is because a standard measure will only work if it doesn't omit important information. Since innovative tariffs will, by their nature, be intended to reflect the heterogeneity of customer preferences, important information will be lost.

Price metrics based on average consumption will be misleading given the wide variation in customers' demand profiles[45] and the fact that the standardised

43 "Cash ISAs: Response to supercomplaint by Consumer Focus", OFT (2010), para. 7.22.

44 "Ofgem's retail market review", Stefan Bojanowski, Oxera (May 2011).

45 For example, the typical annual gas consumption level as published by Ofgem is 16,500 kWH (median). However, 25% of consumers use only 11,000 kWh or less per year and 25% of consumers use 23,000 kWh or more. The standard deviation of gas consumption is 10,500 kWh which is almost as great as the median consumption. "Decision letter: Revision of domestic consumption values", Ofgem (2010), and "Revision of typical consumption values", Ofgem (2010).

element will not reflect all the fixed costs of the business and therefore the standing charges associated with fixed-term products. The comparisons would also fail to capture non-price incentives (such as nectar points).

It is not clear how they could work for customers on existing simple Time of Use tariffs such as Economy 7. Smart meters and more sophisticated TOU tariffs will render unit price comparisons based on average consumption even more meaningless.

Bias towards competition only on price

The promotion of standardised price comparisons is likely to bias competition to focussing on price, at the expense of other important product dimensions. It is well understood competition on other dimensions of the service (e.g. customer service) may be reduced if consumers focus on a single price metric:

"A policy-induced focus on headline price may lead to worse performance on other attributes (such as product quality or small-print charges)… With increased consumer focus on price, price competition is intensified and lower price-cost margins result. Therefore a firm has reduced incentive to expand its market share by boosting its product quality and so chooses to offer a lower quality than before."[46]

3.2 Are the proposals proportionate?

The concerns that Ofgem has identified in its report are not unusual. The Office of Fair Trading (OFT), the Competition Commission (CC), the Competition Appeals Tribunal (CAT) and other regulatory bodies have all looked at markets where there have been concerns that they may work imperfectly due to poor information provision, complexity or lack of transparency. The purpose of this section is therefore to assess whether the remedies proposed by Ofgem are unusual, in comparison to the remedies applied in other cases.

The relevant cases that we have drawn upon are payment protection insurance (PPI) [47], Cash ISAs[48], Personal Current Accounts (PCAs)[49], credit cards[50] and

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46 "Interactions between Competition and Consumer Policy", Mark Armstrong, OFT Economic Discussion paper (2008), p. 65.

47 "Payment protection insurance", OFT (February 2007), "Market investigation into payment protection insurance", CC (January 2009), and "Payment protection insurance market investigation: remittal of the point-of-sale prohibition remedy by the Competition Appeal Tribunal", CC (October 2010).

48 "Cash ISAs: Response to supercomplaint by Consumer Focus", OFT (June 2010).

49 "Personal current accounts in the UK – An OFT market study", OFT (July 2008), "Personal current accounts in the UK – A follow up report", OFT (October 2009), and "Personal current accounts in the UK – Progress update", OFT (March 2011).

50 "Credit card comparison report", OFT (February 2008).

mobile phones.[51] Across these cases, some generic themes emerge that form the basis for the remedies that the relevant authorities have imposed:

- complexity of charges or fees;
- low levels of transparency of charges; and
- barriers to switching providers.

However, while these cases share the same generic features, they also reveal that the scale of these concerns, and the detriments that they cause, vary. With the exception of the PPI, where there were a wider set of concerns raised[52], the remedies were focussed on the provision of information or measures to improve switching. Options that constrained customer choice, for example by limiting offers, were not imposed.

From a review of these cases, we think there are some important lessons that Ofgem should take into account.

- **Take care when standardising comparisons:** Other bodies have taken account of the risk of losing important information when standardising quotations. For example, the CC considered standardising the format of the personal quote in the PPI case. However, it decided that the "quote needed to contain prescribed information …but that some flexibility needed to be built in to accommodate differences in products and potential for future innovation."[53] In the Credit Cards case, Which? had suggested standardising the calculation methods for calculating APR across all providers to avoid the outcome that two cards with the same APR could still have different interest charges due to differences in the calculation methods applied. The OFT rejected this proposal because "[it] would not address the fundamental problems faced by consumers, and could prevent card issuers from offering products which met different consumer needs, as well as reducing product innovation."[54]

- **Help customers to make better choices:** The OFT further concluded in the credit card case that "rather than focusing on standardisation of interest repayment calculation methods, a greater impact could be achieved by helping consumers to choose the best card for their needs."[55]

51 "Mobile evolution – Ofcom's mobile sector assessment". Ofcom (December 2009).

52 For example, the perception that PPI increases the chances of being given credit and the bundling of PPI with credit accounts and merchandise cover.

53 CC (October 2010), para. 10.161-10.163.

54 OFT (February 2008), para. 2.3.

55 OFT (February 2008), para. 2.4.

Recommendations therefore included the introduction of a price comparison website by the FSA, summary boxes of information presented in a consistent way, the standardisation of terminology wherever possible and the establishment of an on-going consumer education strategy.[56] This was also recognised by Ofcom in its assessment of the mobile sector in 2009, where it found that services and offers in the sector were complex and that consumers find it difficult to make informed choices. However, it considered measures to help consumers make informed choice as sufficient (e.g. accredited price comparison websites) and saw no need to apply regulation as "the approach we take to consumer protection and empowerment in the mobile sector aims to strike the right balance between taking timely action when necessary, and the need to apply regulation only when effective and proportionate."[57]

- **Do not unnecessarily constrain competitive behaviour:** The supercomplaint made by Consumer Focus in the case of cash ISAs raised concerns with the introductory bonus rates on cash ISAs that attract consumers and fall subsequently. In the case of cash ISAs, the OFT did not consider these types of offers to cause substantial harm because consumers are aware of this pricing structure and are also informed when the bonus rates no longer apply. For example, in Cash ISAs, the OFT believed that the initiatives around transparency and the transfer process would be more appropriate to address any concerns than "interventionist measures to prevent bonus pricing".[58] It also pointed out that the more intrusive interventions proposed by complainants had the risk of unintended consequences.[59]
  - Banning bonus rates for cash ISAs: This measure would remove an important incentive for consumers search for better deals and switch.
  - Automatic transfer to identical cash ISAs with higher interest rates: This measure would be expected to reduce the incentive for consumers to shop around for the highest interest rates and the incentive for providers to attract new consumers with higher interest rates.
- **Take account of customer inconvenience associated with policy intervention:** The CAT remitted the point-of-sale remedy (where a PPI product would not be allowed to be sold at the same time that the product

56 OFT (February 2008), para. 1.3.

57 Ofcom (December 2009), p. 28.

58 OFT (June 2010), para. 7.31.

59 OFT (June 2010), para. 7.22 and 7.24.

was purchased) for PPI as the 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.

The conclusion to emerge from this review is that Ofgem's proposed interventions are more extreme than those applied by other regulatory and competition authorities in response to concerns about consumer confusion.

3.3 Summary

As we have noted in section 2, the evidence Ofgem has gathered suggests that customers can find it difficult to compare prices and terms. However, the remedies Ofgem propose to deal with this confusion could lead to unintended consequences that far exceed any benefit associated with their introduction. We believe that Ofgem has not taken these into sufficient consideration. We also consider that Ofgem's remedies are disproportionate and interventionist, when compared with precedent from other investigations.

4 Alternative remedies

Ofgem has raised concerns that consumer confusion may have led to a lack of engagement or trust with the industry. If this is the case, policies that reduce confusion so that more customers can play an active role in the energy retail market may be justified. However, as discussed in section 3, we believe that Ofgem's current set of proposals will cause more problems than it solves.

In this section we therefore put forward an alternative set of proposals that Ofgem and the industry could explore further. We believe that this would be more proportionate to the concerns that have been identified and will be expected to come with fewer unintended consequences.

4.1 Policy essentials

Given the evidence base that Ofgem has developed, the objective of intervention should be to support customers in making an effective choice, without limiting that choice. Indeed, limiting choice to deal with consumer confusion should be a last resort and only introduced if there is compelling evidence of both:

- a significant harm associated with customer confusion that is a direct result of the choice on offer; and
- an absence of any other policy that could address the concern at lower expected cost.

As discussed already, we do not believe that either of these tests has been met. Therefore we would caution against implementing any remedy that will restrict product choice or undermine incentives to search the market and switch. This includes both putting limitations on the number of evergreen products and abolishing the automatic roll-over and replacing it with an automatic switch to a prescribed evergreen product.

We also strongly believe that before Ofgem introduces any new policies, it should do two things.

- Further research should be done to understand the appropriateness, and potential unintended consequences, of any remedy before it is imposed. For example, how will customers react to being removed from evergreen tariff offers that they have chosen? There is a risk that such an action could confuse customers further, and potentially lead to greater levels of industry mistrust.

- A more holistic view of the policy landscape should be taken before implementing further change. This means working with Government to avoid multiple proposals aimed at addressing the same concerns. It also requires looking at how interventions would be expected to fit with the direction of future energy policy, particularly given the introduction of smart metering and the requirement for customer engagement to deliver energy efficiency targets.

With these general caveats in mind, we go on to discuss some options for remedies to the problem of customer confusion that may merit further consideration and investigation.

4.2 Proposed remedies

Optimise existing policies first

There is a strong case for allowing time for the Probe remedies to bed down and be developed to their potential before seeing if further action is required. This is not least as the Probe remedy of an annual energy statement would seem to be exactly the sort of intervention that could be expected to help customers: it is based on a measure they understand (£ per year)[60] and should provide the information required so that they know how to change supplier.

It could be developed further (and needs to be from the initial versions put out by industry which were, in some cases, inadequate[61]). In particular, it should clearly show the consumption data they should use when comparing tariffs via a switching site, telesales opportunity or a doorstop seller.

Further, smart meters will act as a catalyst for change. Although the mandated roll-out is still a few years away, these are becoming increasingly commonplace. Making policy consistent with the information that these meters are capable of providing is sensible. In particular, having comparisons based on £spent, rather than units consumed, would appear to be a sensible approach.

It would also be appropriate to wait and see what the proposed impact of Co-operative Energy entering the market will be with its single unit evergreen tariff penalty-free product. Interventions such as compulsory restriction and standardisation of evergreen tariffs will clearly have an impact on entry into this segment of the market. It would certainly be unfortunate if Ofgem's policy intervention compromised the first large-scale entrant into the domestic energy retail market in recent years.

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60 Ofgem refers to research by Ofcom that "consumers may respond better to providing information about total cost on bills than detailed information", "What can behavioural economics say about GB energy consumers?", Ofgem (2011), p22.

61 Subsequent versions of the annual statements have already seen improvements following feedback from customers and consumer groups.

More help with comparisons

Simple pence/unit tariff comparisons will be misleading to customers, be less meaningful than comparisons about annual bill size and be particularly unhelpful when more Time of Use tariffs are introduced as smart meters become more commonplace[62]. Instead we would recommend improving options for customers to be able to get accurate comparisons tailored to their personal situation.[63] This requires two actions.

- First, customers need to be able to get their annual consumption figure. This is on their annual statements, but there could also be a requirement on suppliers to provide it on request.

- Second, they need access to a comparison service that they trust to undertake the comparison for them. For those with internet access this could be via trusted websites. For those without such access it could be by phone or letter, again potentially through trusted third parties such as Ofgem or the Citizens Advice Bureau (CAB).

Thought would need to be given about how this information is presented and whether there is a way of reducing the number of comparisons by pre-selecting categories of products (for example, green energy deals, or by type of payment method).

Smart meters should help in the longer term as they provide better information about energy consumption data and costs that could be used for comparison purposes.

Simplification of information

Perhaps one of the easiest wins is to encourage (or enforce) the use of a common set of language to be used by suppliers when communicating with customers about tariffs and energy bills. Although some suppliers have already simplified the language they use to communicate with customers, there may be benefits to standardising the language used across the industry. This will be expected to increase customer understanding and should also make it easier to educate customers about their energy use and bills.

To maximise the benefit of this exercise, we understand that there may need to be a change to the legal requirements for what appears on a bill. This is

62 Although we believe that tailored comparisons would be the best solution, providing comparisons based on different standard sizes of customer (e.g. small, medium and large) would be preferable to Ofgem's current proposal to provide the comparison only for an average customer.

63 The preference for tailored, rather than standardised, comparisons is consistent with the recommendations from the EU study into retail electricity markets (ECME (2010), p. xix).

particularly important in the case of the information that must appear on a gas bill, which includes information about calorific values and conversion factors that tax even energy sector specialists.

Improved notification of options at the end of a fixed-product

The Annual Statement should already provide all customers with an annual prompt about the options for, and potential benefits of, changing tariff or supplier. We believe this is a good policy. This should be reinforced for those on fixed-product deals that are coming to an end. In such cases, they should be notified that the fixed deal is coming to an end.

Education

The ideal would be to educate customers about their energy use so that they are better able to engage in the market. Consumers have scope for learning. Research undertaken by the OFT suggests that repeated experience with complicated price frames will enable consumers to understand them better.[64] There is a danger that in trying to over-simplify the problem to customers you may actually reduce their ability to engage. This is particularly pertinent given the need to engage customers in further (potentially complex) offerings as part of the Green Deal and smart industry roll-out.

How you do this is an issue that Government, Ofgem, industry and consumer groups should be taking forward as a priority. Since education has public good qualities, it is something best tackled jointly.

Switching

Policies aimed at making switching easier, or even making customers realise that the switching process is not as difficult as they may have thought, are likely to have benefits.

There is evidence that customers do not switch because they fear making the wrong choice[65]. It is therefore worth considering whether suppliers could do more to check that a customer wants the tariff that he has signed up for. For example, a process could be established where suppliers are given a duty of care to see if the customer has switched to an appropriate tariff, perhaps by providing them with alternative product options before they sign up. However, it is worth noting that there is a risk that this could result in greater confusion as customers wonder why they are being offered multiple alternative tariff options when they

64 "The impact of price frames on consumer decision making", OFT (May 2010).

65 Chang and Waddams Price (2008) find that consumers' confidence in their own estimates of the costs and benefits has a significant impact on their searching and switching behaviour and that this is consistent with consumers' wish to reduce their 'regret' in switching decisions. Ofgem also cites "loss aversion" as one of the possible consumer biases in the energy sector.

were quite happy with the choice they had made. It would also need to take into account that some tariffs may not be available to certain customers.

Social policy

Trying to protect customers that are truly vulnerable is better delivered through measures aimed specifically at them (for example through the Warm Home Discount scheme[66]). This is likely to be more effective than weakening competition and penalising those that would otherwise have benefited from competition.

4.3 Summary

The options set out here deal directly with the concern that some customers are disengaged from the market because they find it too confusing. Just as importantly, these options are targeted to that concern, and do not appear to have significant side-effects that would also reduce choice and incentives to search and switch.

66 The Government has estimated that suppliers would be required to spend £310m per year by 2014/15 on this scheme. "Consultation on the Warm Home Discount", DECC (2 December 2010), p. 15.

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