The Retail Market Review: Domestic Proposals

Response to consultation from Morten Hviid, Graham Loomes
and Catherine Waddams, ESRC Centre for Competition Policy[1].

Our main response is to the *Proposals to enhance tariff comparability.*

We reiterate our response to the June consultation[2], though we have become more pessimistic about the net effect of the proposals. We first discuss possible benefits and then our concerns about the potential disadvantages of the proposals. We suggest avenues of research and address some of the detailed questions raised by Ofgem at the end of our submission.

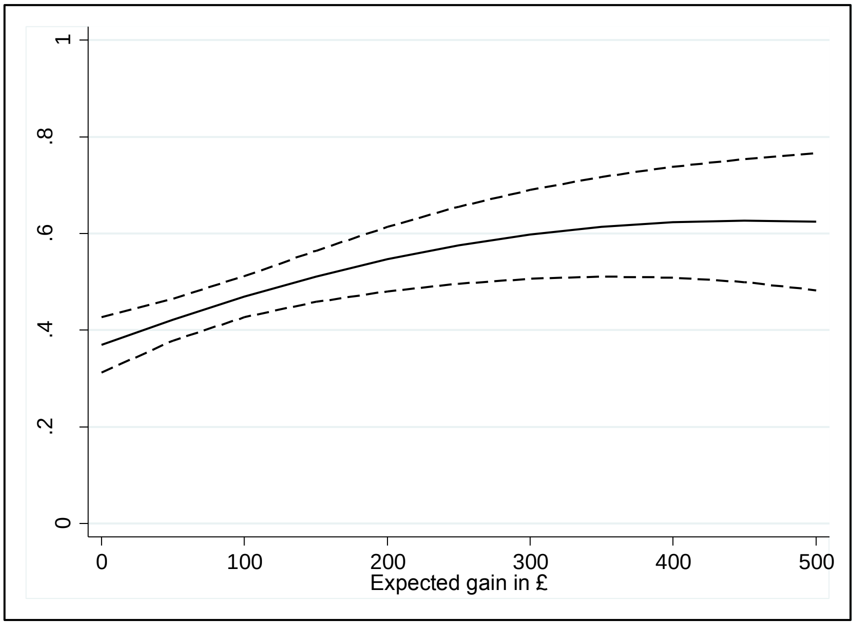
Ofgem have made good progress on removing barriers to consumer understanding of tariffs, in particular training helpers of those who might be asked for advice on the process and other measures to help those who might be less able to make the comparisons and change for themselves. But these measures seem to have had little effect on the overall level of switching, though it would be interesting to know whether Ofgem's research suggests that a higher proportion of consumers deemed vulnerable have changed supplier as a result of these initiatives.

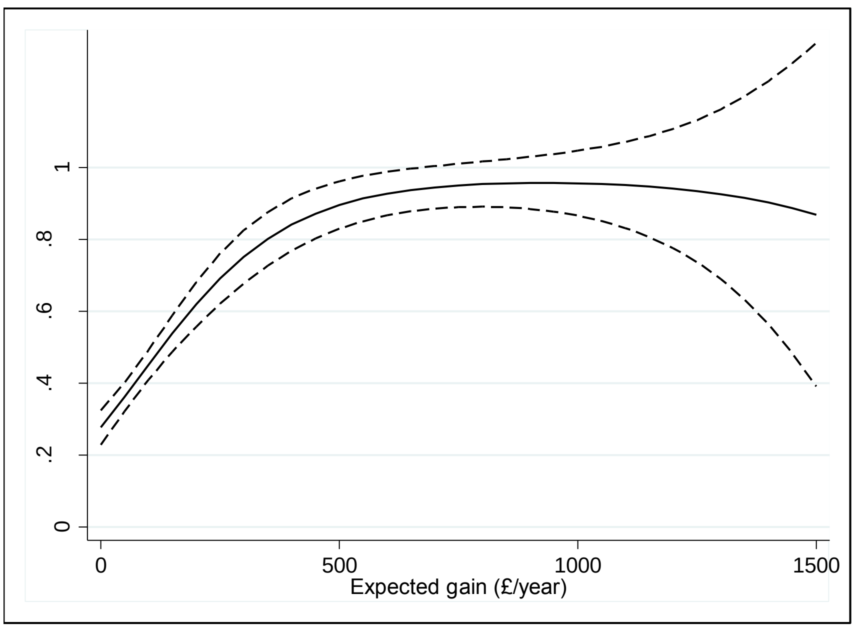
Potential benefits of Ofgem's proposals

Our research[3], as well as that of others, shows that the main driver for those who switch is expected gain. Both the probability of searching and the probability of switching increase with anticipated gain. The most recent (January 2011) survey undertaken by CCP generated the following patterns:

[1] Morten Hviid and Catherine Waddams are based at the University of East Anglia, and Graham Loomes at the University of Warwick.
[2] http://competitionpolicy.ac.uk/documents/107435/107585/Ofgem_response_june_2011.pdf
[3] Effective empowerment: Empirical estimates of consumer switching behavior by Catherine Waddams Price and Catherine Webster, Centre for Competition Policy working paper, University of East Anglia, February 2012

The probabilities of both searching and switching increase with expected gain.





Enabling consumers to calculate expected gain therefore seems to be a necessary requirement for switching. But there is increasing evidence from both Ofgem and our own research that while this may be necessary, it is not sufficient to engender action amongst consumers. On the benefit side, therefore, increasing comparability of tariffs is unlikely to stimulate much more activity on its own, and other measures so far seem to have had little effect.

Moreover anecdotal evidence from discussions with consumers at Norwich 'drop-in switching surgeries' suggests that some consumers don't change supplier because they feel it would commit them to an endless treadmill of checking the market and re-switching. Under Ofgem's proposals this anxiety would be realised, if gains are to be maintained beyond the initial year. So, ironically, the changes might deter rather than encourage some consumers from embarking on a switching route. Of course such anecdotes need to be confirmed by more robust research, as indicated below.

Improved comparability may however improve the quality of those switches that are made. Research from CCP[4] shows that a minority of switchers gain the best deal, while a substantial minority end up with a worse deal (relative to their objectives). Such errors have a detrimental effect both on the switchers concerned and on the disciplinary effect of switching on company behaviour. For those who do switch, therefore, comparability may yield both improved individual and market welfare through improving the quality (but not necessarily the quantity) of switching decisions.

Other factors in the switching decision

One of the innovations in the most recent CCP survey involved the inclusion of various questions designed to tap into people's general attitudes – whether they saw themselves as 'bargain hunters' or whether they were inclined to stick with what was familiar/satisfactory, etc. Such attitudes appeared to be 'clustered' in a natural way and also seemed to be indicative of propensities to search and switch, arguably not only in the energy market but more generally. This raises different questions for different 'types'.

For those whose attitudes make them more likely to engage in search and switching, the primary issue is how best to present relevant information. It would be important to understand how much of any engagement would be focused on special fixed-term deals and how much attention is paid to the defaults.

For those who are predisposed to stick with the status quo, it would be useful to understand what, if anything, might get their attention and whether they could then be engaged sufficiently to switch in ways which would be beneficial to their households and

[4] Do Consumers choose the best suppliers? by Chris M. Wilson and Catherine Waddams Price, Oxford Economic Papers, 62: 647-668, 2010

to the level of competition. One striking feature of the recent CCP survey was the amount of switching that took place in the absence of active searching. This, and the success of direct sales approaches in engaging consumers' attention sufficiently to result in a switch (even if not always in those consumers' best interests) raise the question of whether there are more proactive means of alerting consumers to potential gains and encouraging them, through some impartial advice/agency, to move away from disadvantageous tariffs. With such a strong tendency for a large proportion of consumers to accept a default, there is a need to prompt as much competition as possible between companies' default tariffs in order to prevent them from becoming a vehicle for tacit collusion at the expense of the typical low-engagement consumer. A much better understanding of the psychological as well as socio-demographic factors at work in this large segment of the population would appear to be a high priority. Unless at least a substantial minority of this group can be sensitized to the potential gains from switching, the provision of simplified tariffs alone is very unlikely to have the desired effect.

Potential drawbacks of Ofgem's proposals

Ofgem reiterates its belief in the competitive market to protect consumers, but at the same time proposes a heavy intervention in the market which is likely to dampen competition. There is a danger, also evident in the non discrimination clause debate, of confusing conditions which would emerge from a static competitive equilibrium with those which are necessary for dynamic competition to develop. Ofgem's analysis and diagnosis suggests that we are far from a desirable competitive outcome at the moment, and so we need conditions that will encourage competition, not dampen it.

The likely response of companies to these changes raises most concerns. These are likely to be one of two kinds. At one level, the automatic default from non-standard to standard tariffs appears to encourage a bait and switch model, in which the non-standard tariffs are the bait, with low profit margins but good temporary bills for those who take them, while profits are recouped on the standard tariffs to which switchers default if they do not remain active. Regulatory intervention to enshrine such a process in the market seems somewhat perverse. This was one consequence of the non discrimination clauses[5] which resulted in the plethora of offers which Ofgem now deplores and wishes to discourage. Yet at one level Ofgem should be encouraged that companies are continuing to compete vigorously for some consumers, despite the 'easy life' which the non discrimination clauses offered them.

However such favourable offers will continue only if companies perceive them as profitable, i.e. they recoup the costs of acquiring consumers through returns made after they have defaulted onto the standard tariffs. This will exacerbate the gap between non-standard tariffs and standard tariffs. To the extent that vulnerable consumers may not switch at all, they will be the losers from this.

So too, will be the majority of those who have switched who have been receiving dual fuel discounts. In its Market supply Probe, Ofgem reported that of those consumers who were on the gas grid, 90% of switchers in the year to 2008 took a dual fuel supply, and that overall there were 14.8 million dual fuel customers representing around two-thirds of all consumers with both an electricity and gas supply. All these consumers will be able to retain such a discount only by repeated annual switching onto non standard products. We note above concerns by some consumers about such a treadmill which would deter them from switching.

Ofgem acknowledge the potential harm to competition in their impact assessment – indeed recognise that such bifurcation of the market has already occurred, and suggest that it may not matter that it would be further encouraged by these measures. However its further entrenchment would be detrimental, and we believe that Ofgem have seriously underestimated the adverse effects on competition.

If companies do not think they can entice enough consumers onto more profitable standard tariffs through their non standard offers, the latter will be reduced, leaving only the standard tariffs. It is possible that active consumers, faced with only the standard tariffs to choose from, will switch between companies sufficiently often to generate real competitive pressures. But with Ofgem fixing one element of the tariff, it will be very easy for companies to take an easy route and not to compete vigorously with each other on the energy element. Moreover if prices cannot be raised within a significant period of

[5] See our response at http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Response%20from%20Catherine%20Waddams%202.pdf

time, such as six months, the energy elements will be higher to hedge the risks for companies that upstream costs will rise during this period.

Ofgem perceives the problem as being that a lot of consumers are inactive in the market, i.e. that there is little effective competitive pressure for the non-switchers so that companies can charge them a higher price. Ofgem's proposed remedy is that if a consumer is active, after 12 months, they are switched to the default tariff of its supplier unless they take further action. The outcome of this is that it is non-switchers and the 'occasionally engaged' who will be on the default tariff.

But these are the consumers to whom higher prices can be charged without risk of losing them. The result is likely to be range of excellent temporary deals, as firms may use this one-off high profile switching opportunity, which will be widely advertised by Ofgem and others. Competition to gain consumers for the first twelve months may well be fierce, leading to low prices and high switching rates in this period. Future profits from non-switchers will be used to cross subsidise these prices and hence switchers will likely gain not just relatively but also absolutely. Such apparent success would in effect conceal a serious failure of regulation. There will be little competition for the non-switchers after the initial period, and it is not clear that the period of intense competition will be repeated.

From a distributional perspective this is especially worrying because it creates a way for the firms to fully identify and ring-fence the non-switchers and exploit them maximally. If these are particularly vulnerable consumers, or those for whom the regulator has a statutory responsibility, the cure may prove worse than the disease.

Implications for marketing

Forcing the focus simply on price and banning lump-sum discounts such as for dual fuel reduces the possible avenues through which companies can market their products. It may well be that it is more effective (in terms of attracting customers) to offer a lump sum saving of £30 than to discount by 5p per unit sold. Indeed this is exactly what evidence from the real world of retailing (including energy) shows. In our summary of the literature on behavioural remedies[6], one robust finding was that firms are generally better than regulators at communicating with consumers.

Moreover in abolishing the dual fuel discount, Ofgem is removing a major tariff innovation in the market – one of the claimed benefits of introducing competition. By imposing simpler tariffs on all suppliers, Ofgem will foreclose simplicity as a competitive advantage, which has been advertised as a major benefit by one of the recent smaller entrants.

Concerns about tacit coordination

Although not discussed much in the literature on tacit collusion, the less costly it is for firms to monitor their rivals' prices, the more likely they are to be able to suspend competition successfully. Given the small number of firms and the nature of the product, one of the few obstacles to classifying this as an industry with ideal conditions for tacit collusion is transparency, which has up to now been somewhat complicated by the large number of tariffs and their non–linear nature. If Ofgem's proposals work as they hope, which we seriously doubt for the reasons stated above, this would remove a major barrier to easy collusion.

Concerns about costs

While Ofgem's innovations may reduce regulatory costs, they are likely to increase costs both for companies and consumers. The requirement to switch supplier annually will impose higher costs on both parties, all of which will eventually be recouped from consumers.

Consumer behaviour

We welcome Ofgem's proposal to make the results of their consumer research more widely available, and would appreciate opportunities to identify how our own research into consumer behavior and theirs could be made comparable, so as to benefit both research knowledge and policy outcomes.

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[6] *Assessing the Effectiveness of Potential Remedies in Consumer Markets*, a report for the Office of Fair Trading by Luke Garrod, Morten Hviid, Graham Loomes and Catherine Waddams, 2008, http://www.oft.gov.uk/shared_oft/economic_research/oft994.pdf

Vulnerable consumers

Ofgem proposes a number of measures to protect vulnerable consumers, and states "Those consumers who are vulnerable are more likely to be disengaged or "sticky" consumers". Our own data confirm that consumers in one or more vulnerable group are less likely to switch, but that a large proportion of such consumers have switched at least once – see for example the following table[7]: this shows that while a lower proportion of 'vulnerable' consumers had switched away from the electricity incumbent in 2005, a majority (53%) had done so, and would have been disadvantaged by policies which directly or indirectly penalized those who had switched.

More generally, competition is a poor instrument for delivering social outcomes, which are best delivered alongside market mechanisms. If protection of consumers, particularly the vulnerable, is the main objective, regulation is likely to be a more appropriate tool.

Table 1: % of consumer groups with different suppliers for electricity

Vulnerable group	proportion of respondents in vulnerable group	% of vulnerable group supplied by:		
		Incumbent electricity co	British Gas	Entrants
All respondents	100%	42	32	26
Over 65	15%	46	28	26
Low income	40%*	47	31	22
Disabled	9%	44	28	28
Rural	16%	60	20	20
Low educational attainment	20%	52	27	22
Without Broadband	65%	45	31	24
At least one of the above	56%	47	29	24

* There was a high refusal rate for the income question; Low income households were classified as those stating gross earnings were less than £15,499 per year, compared with national average gross annual earnings of £21,736 in 2005.

Source: Primary data from CCP consumer survey 2005

[7] From Non-discrimination clauses in the retail energy sector (by Morten Hviid and Catherine Waddams), forthcoming, Economic Journal, earlier version available at http://competitionpolicy.ac.uk/documents/107435/107587/CCP_Working_Paper_10_18.pdf

Specific questions

Question 1:

Do stakeholders agree that we should introduce the RMR core proposal?

No, because of the dangers outlined above

Question 2:

Which cost elements should be included in the standardised element of standard tariffs?

There is a real danger of introducing a regressive tax if social and environmental policy costs are included, which will effectively be the charge on each household. We outlined this in our June response. Since the vast majority of this seems to arise from government and regulatory policy, it would be more appropriate to recover it through an income related charge, not a constant charge per consumer. . We plan to respond more fully to the separate consultation on the standing charge elements.

Question 3:

Do stakeholders agree that our information remedies would help consumers engage effectively? If not, what would be more appropriate remedies?

No, we do not believe that they would be sufficient

Question 4:

Do stakeholders consider that the price comparison guide should be presented in a p/kWh figure, a £ per month figure or both?

Both

Question 5:

Do stakeholders agree that the proposed exceptions for legacy social tariffs and extremely high consumption domestic consumers are appropriate?

No view

Question 6: *Do stakeholders agree that we should not allow an exception for suppliers to offer a green standard tariff in addition to an „ordinary" standard tariff?*

No, since we answered negatively to question 1.

Question 7:

Do stakeholders believe it would be appropriate to introduce a six-month price guarantee for standard tariffs, or do you consider that this would undermine the simplicity of the RMR core proposal?

No. It would encourage higher prices as a hedge against future upstream cost rises

Overall assessment

Ofgem's proposals seem to be plugging a dyke as successive holes appear, each initiative trying to eliminate undesirable effects of the previous intervention, and generating increasingly intrusive regulation. Given the higher costs expected upstream and from government environmental and social policy, prices will continue to rise, for good reasons. A more honest response would be to acknowledge this. If vulnerable consumers are a concern, they can be protected through collective buying or a subsidised and regulated tariff, though European Directives may limit the scope for this.

More limits on the supply side, for example through limiting the range of tariffs permitted, are likely to inhibit innovation and competition. The regulator should decide whether competition or regulation is appropriate for the market – at the moment we fear that their attempts to deliver social outcomes through a competitive market are likely to achieve the worst rather than the best of both worlds.

About the ESRC Centre for Competition Policy

The ESRC Centre for Competition Policy (CCP) is an independent research centre, funded by the Economic and Social Research Council (ESRC) and established in 2004 as a ten-year Centre of Research Excellence. CCP's research programme explores competition and regulation policy from the perspective of economics, law, business and political science. CCP has close links with, but is independent of, regulatory authorities and private sector practitioners.

The support of the ESRC is gratefully acknowledged. The views and statements expressed are those of the authors and do not necessarily reflect the views of the ESRC.