Ofgem: Response to 'Opening Statement – Strategic Review of the microbusiness retail market call for evidence

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Consultation response from the

Centre for Competition Policy

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for its content.

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Response to 'Opening Statement – Strategic Review of the microbusiness retail market call for evidence'

We welcome the opportunity to provide evidence relevant to Ofgem's Strategic Review of the Microbusiness Retail Market. We respond to those questions where we have relevant material or ideas to contribute. Unless otherwise stated, the analysis in Deller and Fletcher (2018)[1] is based on Ofgem's 2014 Micro and Small Business (MSB) engagement survey.

Question 1 – Theories of Harm

The theories of harm seem to broadly cover the core areas where the microbusiness retail market might be failing relative to an 'ideal' market. However, it is far from clear that the microbusiness market can be moved significantly closer to the 'ideal' situation. The apparent failure of the CMA's price transparency remedy to have a significant beneficial impact directly illustrates this point. In particular, regarding theories of harm 1) and 5), it appears that there are aspects of the microbusiness market relating to the nature and variety of contracts that make price comparison intrinsically harder than in the domestic retail market. If suppliers, third-party intermediaries and well-informed microbusinesses all believe and behave in a fashion where achieving the best deals requires negotiation, it is likely to be difficult to shift the 'equilibrium' of the market to one where online price comparison is the norm.

Given the negative conclusions in the CMA's Energy Market Investigation regarding Ofgem's simpler tariff interventions as part of the Retail Market Review[2], it would seem a mistake to place restrictions on the nature of contracts simply to facilitate easier price comparison by microbusinesses. A more sensible strategy would be to investigate the feasibility of elaborating on the existing price transparency rules so that the required quotation tools are better able to identify the deals most appropriate to microbusinesses' needs. Indeed, a sensible starting point would be to enforce the Standard Licence Condition around the existing price transparency remedy, as significant non-compliance has been identified.[3] However, realism is needed regarding the size of improvements that are likely to result from incremental changes.

Regarding theory of harm 2), while on average it may be true that microbusinesses consume more energy than domestic households and so have higher monetary savings available from switching, statement 2) may not be true in all cases. Deller and Fletcher (2018) report that 21.8% of MSBs were estimated to have energy expenditures below £1,000 in 2014.[4] Also, even if the costs of not engaging are higher for microbusinesses than households, the costs of engaging, in terms of the opportunity cost of allocating time to engaging, may also be higher for microbusinesses.

Related to the above point, and theory of harm 4), it is possible that some microbusinesses are taking a conscious decision not to engage on the basis that energy is a small factor influencing their overall profitability and so they instead allocate time to optimising business activities with a greater influence on their profitability. As a result, some caution is needed before viewing 'lack of engagement' as

[1] Deller, D. and A. Fletcher (2018), 'Micro and Small Businesses' Satisfaction with the UK Energy Market: Policy Implications', CCP Working Paper 18-9, Centre for Competition Policy, University of East Anglia, available at: http://competitionpolicy.ac.uk/documents/8158338/24898393/CCP+WP+18-9+complete.pdf/785c6290-7ebe-350a-0af2-6b97a1fb7a0d

[2] See paragraphs 9.507-9.513, pg 576-577, CMA (2016), 'Energy Market Investigation – Final report', available at: https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

[3] See Figure 4.1, pg 15, Ofgem (2019), 'Evaluation of CMA Price Transparency Remedy – final report'

[4] Figure E5, pg43, Deller and Fletcher (2018)

always being a problem. That Ofgem's review of the price transparency remedy suggests finding a new energy deal might take 4 hours[5] emphasises the potentially high cost of engagement for microbusinesses: 4 hours spent contacting potential customers may generate more revenue for a microbusiness than the saving from switching energy supplier. Even 2 hours to identify a good energy deal, i.e. halving the current time, would likely represent a significant opportunity cost.

Deller and Fletcher (2018) suggest that the simplest explanation for MSBs with low energy expenditures reporting greater satisfaction with their current energy supplier's value for money and overall service is that for MSBs with low energy consumption the cost of energy has low salience. In other words, if an MSBs' energy expenditure is low in absolute terms an MSB may simply be satisfied by having a reliable energy supply.[6]

Furthermore, Deller and Fletcher (2018) report that in 2014 MSB switching rates were noticeably higher than for residential households.[7] Deller and Fletcher report that, in 2014, 59.8% of MSBs were estimated to have switched at least once in the 5 years prior to the survey and 23.4% had switched in the 12 months prior to the survey. This compares to an equivalent 12-month switching rate of 13% for domestic households 2014. Also, the 12-month switching rate for MSBs needs to be adjusted to account for the high proportion of MSBs on multi-year contracts[8], i.e. MSBs unable to switch in a given year. Accounting for these multi-year contracts, leads to a 12-month switching rate of 34.3% among those firms able to switch. However, Deller and Fletcher do note that looking at other years (in particular 2013) and other data sources (the aggregate switching statistics) suggests a lower level of engagement by MSBs.

Question 3 – Raising Awareness

As noted above, the fundamental issue around awareness and engagement is whether understanding and engaging with the energy market represents a good use of microbusinesses' time relative to other business activities. If communication efforts are to be useful, it seems important that they are appropriately targeted at those microbusinesses who are likely to be experiencing the most harm/would benefit the most from engagement.

Following this approach suggests two types of microbusinesses for attention. First, microbusinesses with large energy expenditures might be targeted. In particular, awareness might be maximised by joint communications with industry associations for those sectors with particularly high energy requirements, e.g. pottery and baking etc. It would also be interesting to explore whether these industry associations can simplify the energy purchasing process for their members by partnering with third-party intermediaries to collectively negotiate competitive energy deals.

Second, MSBs experiencing the highest unit costs of energy might be targeted. The CMA's Energy Market Investigation highlights that the highest unit costs are faced by businesses with deemed and out of contract tariffs.[9] Since these two types of tariffs are intended to be transitory until a microbusiness signs a full contract, it seems reasonable to target communication efforts at

[5] Paragraph 4.13, pg18, Ofgem (2019)
[6] Section 5.3, pg18-23, Deller and Fletcher (2018)
[7] See section 5.1.1, pg 9, Deller and Fletcher (2018)
[8] Deller and Fletcher report 53.9% of MSBs were estimated to have a fixed-term contract lasting 2 years or more in 2014.
[9] See Figures 15-18, pg51-54, CMA (2016), 'Energy Market Investigation: Appendix 16.1 – Microbusinesses', available at: https://assets.publishing.service.gov.uk/media/576bccc4e5274a0da9000084/appendix-16-1-microbusiness-aec-finding-fr.pdf

highlighting to these microbusinesses that their current supplier will have lower priced tariffs available. This communication might include a form of cheaper tariff messaging on bills.

Last, it seems sensible to delay communication efforts until any issues identified with the online quotation tool are rectified. Directing microbusinesses to a 'clunky'/inadequate tool may reinforce negative perceptions about the ease of comparing tariffs thereby deterring future microbusiness engagement.

Question 4 – Searching the Market

Our main comments on microbusinesses' ability to compare energy deals relate to the role of brokers and are provided in our response to question 6.

Here we provide satisfaction results reported in Deller and Fletcher (2018) from 2014 that are pertinent to microbusinesses' ability to compare energy deals. First, MSBs had a positive skew regarding satisfaction with the tariff information provided by their current supplier: 48.6% reported being quite or very satisfied compared to 20.5% who were quite or very dissatisfied.

Second, regarding the ease of comparing prices and the advice available when switching, MSBs' views were broadly neutral. For the ease of comparing prices, 38.8% of MSBs were quite or very satisfied compared to 33.7% who were quite or very dissatisfied. For the advice available when switching, 33.4% of MSBs were quite or very satisfied against 30.9% that were quite or very dissatisfied.

Third, MSBs held noticeably negative views regarding the sales approaches of brokers and energy suppliers. For energy suppliers' sales approach, 37.4% of MSBs were quite or very dissatisfied compared to only 21.3% who were quite or very satisfied. For brokers' sales approach, 48.8% of MSBs were quite or very dissatisfied compared to only 19.7% that were quite or very satisfied. Last, regarding MSBs' overall opinion of brokers, 45.3% of MSBs held a quite or very negative opinion compared to only 22.4% who held a quite or very positive opinion.

Question 5 – Entering New Contracts

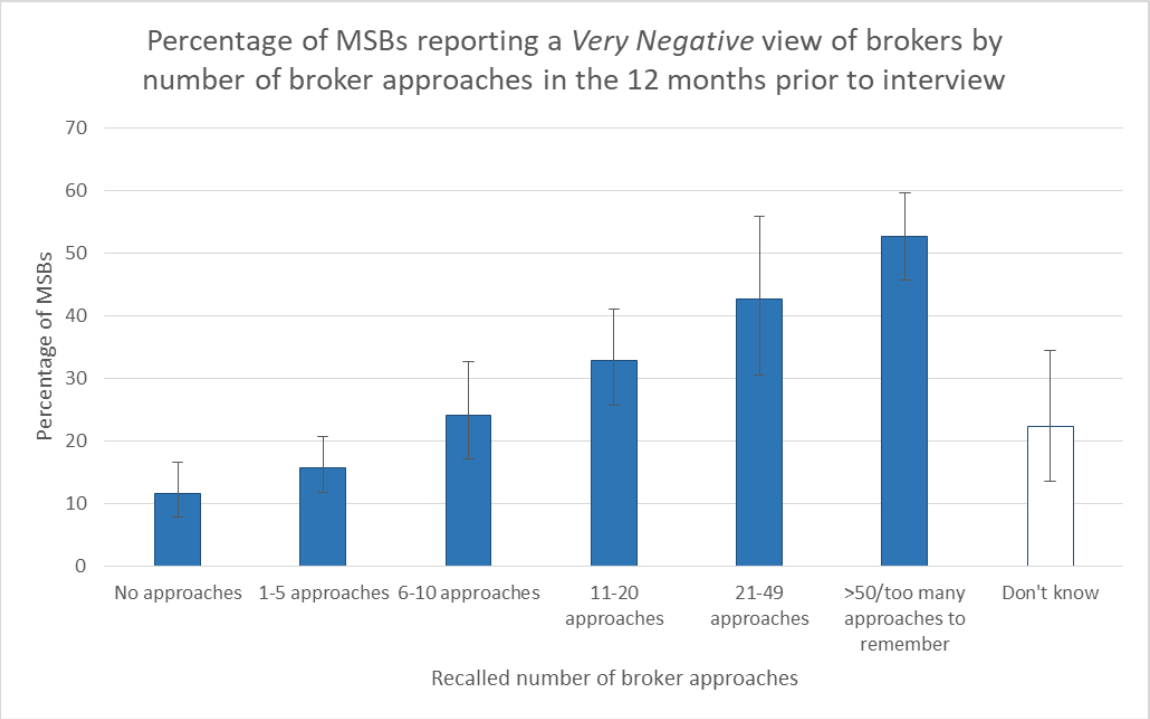
It seems important that Ofgem fully understands why businesses select particular types of contract/contract terms. The high percentage of MSBs reporting multi-year fixed term contracts in the 2014 suggests that many MSBs could be interested in the stability of their energy price over time as well as its initial level. If MSBs are looking to manage risk with the type of contracts they select, the management of risk may also play a part in their switching behaviour: some firms may erroneously worry about switching supplier introducing a risk of an interruption to their energy supply.

Question 6 – Malpractice by Brokers

The evidence in Deller and Fletcher (2018) clearly shows the strong association between MSBs using a broker as their main choice method and switching energy supplier. This association between broker use and switching emphasises why the identification of malpractice by brokers would be particularly concerning: it could deter MSBs from using perhaps the easiest way to search across energy deals provided by a range of suppliers. Deller and Fletcher (2018) find that MSBs stating that they mainly chose their current energy supplier after contacting a range of different suppliers were associated with having a probability of having switched in the five years prior to the survey 18.5-19.8 percentage

points lower than for MSBs stating they had used a broker as their main choice method.[10] This result is statistically significant at the 1% level.

While not necessarily an example of malpractice, i.e. something contravening the spirit of regulations or the law, Deller and Fletcher (2018) provide direct evidence of how high levels of contact from energy brokers can reduce MSBs' satisfaction with them. High levels of reported marketing contact from brokers are associated with MSBs having more negative opinion of brokers. This could be detrimental if this more negative opinion of brokers translates into MSBs being less likely to use a broker to search the energy market. The chart below highlights how those reporting a large number of broker approaches in 2014 were more likely to hold a 'very negative' opinion of brokers. While 15.7% of MSBs recalling 1 to 5 broker approaches in the 12 months prior to the survey held a 'very negative' opinion of brokers, this rose to 52.7% for MSBs recalling over 50 approaches or too many approaches to specify.



Deller and Fletcher (2018) run ordered logit regressions to provide a more detailed assessment of the association between broker contact and MSBs' opinion of brokers after controlling for a comprehensive range of other explanatory variables. When the number of broker approaches is treated as categorical variable, reporting 6-10 broker contacts instead of 1-5 broker contacts is associated with a drop in the odds[11] of having a more positive view of energy brokers of more than 40%. When the number of broker approaches is treated as a continuous variable, receiving each additional broker approach is associated with 1.2% drop in the odds of having a more positive opinion of brokers. Both of these results are statistically significant at the 1% level. These results hold after controlling for whether an MSB used a broker as their main choice method.

[10] See Table A1, pg 30, Deller and Fletcher (2018). The same result of not using a broker as one's main choice method being associated with a lower probability having switched was also found using Ofgem's 2015 survey data, although, the magnitude of the effect was smaller being 10.1-10.8 percentage points. See Table D5, pg 40, Deller and Fletcher (2018).

[11] The odds are defined as the probability of being above a particular satisfaction level, e.g. quite satisfied, divided by the probability of being below or equal to the same satisfaction level.

While broker contact may be disliked by MSBs, the key policy question, since the use of brokers is strongly associated with having switched, is the extent to which any attempts to limit the quantity of marketing communications by brokers would reduce switching. Key to answering this question is whether a significant proportion of switches are triggered by unsolicited contact from brokers, or whether most MSBs proactively approach the broker they subsequently use in the switching process. Unfortunately, the survey data available to us did not provide evidence on this point, but it is something Ofgem would benefit from investigating further.

Deller and Fletcher (2018) also report some evidence that reporting a large number of broker approaches is associated with reduced odds of having higher satisfaction with the ease of comparing prices in the energy market. However, this piece of evidence should not be over-emphasised as the association is noticeably weaker than for the association between broker contact and the opinion of brokers, and it is also less straightforward to interpret.