

Impact Assessment

Microbusiness Strategic Review: Updated Impact Assessment

Division:	Retail	Type of measure:	Retail Competition measures
Team:	Retail Policy Team	Type of IA:	Qualified under Section 5A UA 2000
Associated documents:	Microbusiness Strategic Review Statutory Consultation	Contact for enquiries:	CDconsultations@ofgem.gov.uk
Coverage:	Full coverage		

Overview

This is an impact assessment on policy changes to improve the microbusiness supply market. The policy changes are explained in more detail below and in the accompanying statutory consultation.

This document assesses the impact these changes will have on microbusiness customers, brokers, and suppliers. Our analysis suggests that, overall, the policy package will deliver positive net benefits to microbusiness customers.

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1. Summary

Introduction

What is the problem under consideration? Why is Ofgem intervention necessary?

Our evidence base indicates the microbusiness retail market is not working well for some customers. Too many microbusinesses are encountering opacity, poor sales practices and barriers that can leave them overpaying for energy. This includes a lack of transparency of costs in the contracting process that is hindering microbusiness customers' ability to find and agree suitable energy contracts and resolve disputes when they arise.

Our proposed policy package aims to reduce these impacts and improve how the market functions, thereby improving outcomes for microbusiness customers.

What are the policy objectives and intended effects including the effect on Ofgem's Strategic Outcomes?

Our primary policy objective is to improve the functioning of the microbusiness retail market by improving customer service and lowering costs. To help achieve this objective we have developed a customer journey model and theories of harm. Alongside evidence collected in our consultation processes, these were used to help us identify and prioritise issues impacting microbusiness customers. This then allowed us to develop targeted policy interventions designed to meet our objectives.

Our policy aim is for microbusiness customers' experiences to better match the principles in the customer journey model. These reflect Ofgem's strategic priorities of protecting consumers by stamping out poor practices, ensuring fair treatment and enabling more effective competition.

What are the policy options that have been considered, including any alternatives to regulation? Please justify the preferred option (further details in Evidence Base)

Our preferred option is to implement the policy package set out in the accompanying statutory consultation document and summarised below.

We considered this against the existing arrangements. We consider the existing arrangements are not suitable for the reasons explained below.

Preferred option - Monetised Impacts (£m)

Business Impact Target Qualifying Provision	NA
Business Impact Target (EANDCB)	NA
Net Benefit to GB Consumer	NA
Wider Benefits/Costs for Society	NA
<p>Explain how the Net Benefit was monetised, NPV or other (<i>eg NPV calculated using 2016 as base year. Economic costs and benefits are in 2015 financial year prices covering the period from 2016 to 2020</i>).</p> <p>Where possible we have calculated the financial costs and impacts of our policy proposals. For example, we estimate that the cooling-off period would create at least £2.05M of benefit per year to microbusinesses through avoiding overly costly deals.</p> <p>However, the impact of our policy package cannot be fully monetised. This is because some of the changes we propose involve market impacts that are difficult to monetise, for example, providing microbusinesses with clearer information to make more informed contract choices. It is difficult to monetise these benefits in a market in which most customers are on a negotiated fixed term contract and may use a broker to negotiate a deal. Where we have not been able to monetise a benefit or cost, we have provided a non-quantified judgement about the impact based on evidence collected through the Review.</p>	

Preferred option - Hard to Monetise Impacts

Describe any hard to monetise impacts, including mid-term strategic and long-term sustainability factors following Ofgem IA guidance

Our evidence suggests some microbusiness are paying unjustifiably high broker fees. The policy package will make brokerage costs more transparent to microbusiness customers. This will allow microbusiness customers to make more informed contract choices. There is a range of estimates about the number of microbusiness customers who use a Third Party Intermediary (TPI) to secure energy contracts. The prices paid for TPIs services are also not routinely reported to us. This makes it difficult to monetise a benefit across all microbusiness customers.

We have based our analysis on the benefits of price transparency for microbusiness customers. These benefits will help address the existing practices that can lead to customers signing up to overly costly deals.

Key Assumptions/sensitivities/risks

We primarily used data for calendar year 2019 to inform our cooling-off period analysis. Data for 2020 was not used due to impacts the covid-19 pandemic had on the market.¹ Data for calendar years 2017 to 2020 was used to inform our risk premium analysis. There is some uncertainty about the amount of microbusiness customers who will use a cooling-off period. We have used the amount of domestic customers who utilise a cooling-off period as a proxy for microbusiness customers.

Will the policy be reviewed?	No
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Is this proposal in scope of the Public Sector Equality Duty?	No
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¹ This included consumption and contract price data.

2. Background

This section explains the background to the Microbusiness Strategic Review and summarises responses to the Draft Impact Assessment published in July 2020. It also sets out our proposed package of policy interventions.

Introduction

Microbusinesses continue to play a central role in the UK economy, providing a wide range of products and services. Latest government data suggests that there were over 5.7 million microbusinesses in the UK by 2020, accounting for 96% of all businesses, 33% of employment and 21% of turnover.²

Microbusinesses³ are equally important in the retail energy market. As of December 2020, the largest suppliers (who supply approximately 90% of the microbusiness market) provided supply to circa 1.4m electricity and 0.5m microbusiness gas meter points.⁴ Microbusinesses make up a significant proportion of energy expenditure too, with expenditure from all these meter points accounting for £3.4bn in 2020.⁵

Several interventions have been made in the past to the regulatory framework to improve microbusinesses experience in the energy market. These include introducing 'Standards of Conduct' to set overarching rules for suppliers to follow when engaging with microbusinesses in 2013 and the Competition and Markets Authority's (CMA) price transparency remedy which took effect in 2017.

² This data is from the House of Commons Library (2020). The document is linked below and contains relevant definitions: <https://researchbriefings.files.parliament.uk/documents/SN06152/SN06152.pdf>

³ From this point onwards, where we refer to 'microbusinesses' we are referring to microbusinesses as defined in the Gas and Electricity supply licences.

⁴ These values refer to microbusinesses that have a non-domestic energy contract and are compiled using an ongoing request for information to suppliers that represent approximately 90% of the small business market segment. These suppliers are British Gas, Corona, EDF, Eon, Gazprom, Npower, Opus, Scottish Power, SSE, and Total Power for electricity, and British Gas, CNG, Corona, EDF, Eon, Gazprom, Npower, Opus, Scottish Power, SSE, TEGS, and Total Power for gas.

⁵ This figure is calculated from our ongoing request for information.

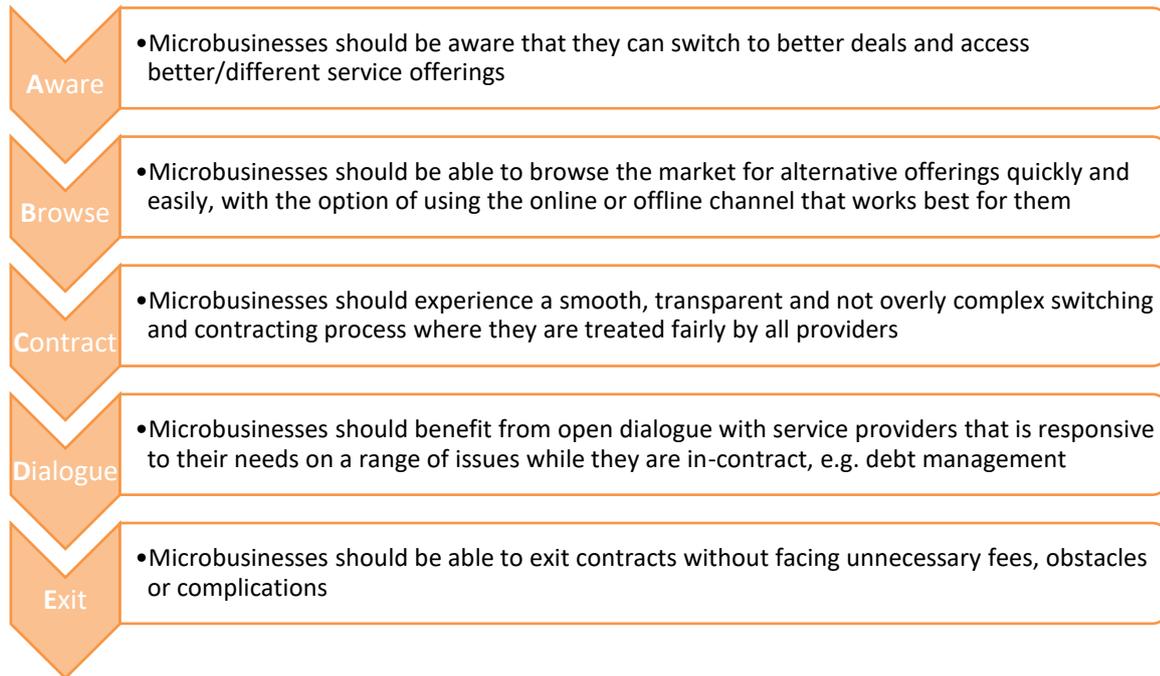
Despite these interventions, our evidence base, coupled with concerns expressed by a range of stakeholders suggested that the functioning of the microbusiness energy market was not resulting in good outcomes for some microbusinesses. Our micro and small business survey also identified that a significant proportion of microbusinesses are not engaging with the market and accessing the best deals. The 2018 survey found that of those businesses undertaking no switching activity, 43% believe that all suppliers charge the same and 51% believe the differences between deals are marginal.⁶

In our Forward Work Programme 2019-2021, we noted that microbusinesses face many of the same issues as domestic customers when engaging in the retail energy supply market. In 2019, we launched our Microbusiness Strategic Review (MBSR) to understand better what these issues are and what actions can be taken so that all microbusinesses can access a competitive retail market with appropriate levels of consumer protection.

We want to see a retail market where providers meet microbusiness' needs and preferences; where microbusinesses receive appropriate protection and great customer service; and can easily navigate and access competitive offerings to make informed decisions.

To help us assess what issues were impacting microbusinesses, we developed a customer journey model. The customer journey model is shown in the graph below. It details a set of practical principles which we consider should be applied at each stage of the journey.

⁶ Ofgem, Micro and small business engagement survey (2018), https://www.ofgem.gov.uk/system/files/docs/2018/10/micro_and_small_business_engagement_survey_2018_report.pdf



Consultation activities

In May 2019 we published a Call for Inputs (CFI) which sought views on the harms and issues microbusinesses face when engaging in the market. The CFI explained the customer journey model and sought views and evidence of harms microbusinesses face at each stage of the journey. A wide range of stakeholders responded to the CFI setting out views on the issues faced by microbusinesses. We added this feedback to other evidence sources collected and analysed by us to identify and prioritise the harms impacting microbusinesses according to their scale and severity.

In July 2020 we published a policy consultation that set out a proposed package of reforms to address the harms we prioritised. The proposed changes included:

- **Broker conduct principle and Informed contract choices:** Introducing a principles-based requirement for suppliers to ensure brokers they work with conduct themselves appropriately; and applying targeted sales and marketing rules to suppliers and brokers they work with via supply licence changes
- **Broker dispute resolution:** Introducing a requirement for suppliers to only work with brokers signed up to an alternative dispute resolution scheme
- **Broker commission transparency:** Clarifying and strengthening existing supply licence obligations to provide information about broker commission payments on contracts, bills, and account statements

- **Cooling-off period:** Introducing a 14-day cooling-off period for microbusiness contracts
- **Contract extensions:** Requiring suppliers to maintain existing contract rates for up to 30 days while issues with a blocked switch are being resolved
- **Banning notification requirements:** Banning suppliers from requiring microbusinesses to provide notice of their intent to switch
- **Awareness raising** working collaboratively with leading consumer groups to improve awareness and raise information and materials provision.

A draft impact assessment accompanied the policy consultation. The draft IA set out our initial high-level views on the impact of the proposed policy package. It also requested additional information and views from stakeholders about the impact of each policy measure. Key points from the responses to the draft IA are set out below.

Draft IA responses

Eleven responses were submitted to the draft IA. We also used relevant evidence submitted to the policy consultation as additional information for the purposes of the draft IA. The responses were mostly submitted by suppliers and eight were submitted on a confidential basis. The non-confidential responses can be found on our website. We have summarised the feedback below.

Broker conduct principle and informed contract choices

We received information related to the costs of implementing a Broker Conduct Principle (BCP) and Informed contract choices. These were divided into existing monitoring costs, new monitoring costs and implementation costs.

Several suppliers set out their existing TPI monitoring costs. These are the costs suppliers incur at present to monitor contract sales made through a broker. These costs ranged from around £30,000 pa to £100,000 pa. Several suppliers also estimated additional ongoing monitoring costs that would be required by the BCP. These ranged between £60,000 pa and £200,000 on top of existing monitoring costs. These costs included additional staffing and auditing resources required to monitor broker engagement.

One supplier estimated BCP implementation costs of around £85,000. These implementation costs related to IT system changes. Another supplier noted that complex IT

system and process change costs would be required to implement the proposal. They noted that changes to their current IT systems were already being made which would be further complicated by additional changes. Two other suppliers estimated 'high' implementation costs but did not provide any figures.

Several respondents noted costs to implement informed contract choices would be the same as those required to monitor brokers' application of the BCP. Two stated that costs depend upon the compliance framework Ofgem expect suppliers to use when implementing the change.

ADR Scheme

We received limited feedback on estimated costs to introduce an ADR scheme. Respondents noted these costs would be borne by TPIS.

Cooling-off period

Several respondents estimated a low utilisation of a cooling-off period by microbusiness customers. In two cases, these claims were supported by analysis of internal complaints data. While this feedback is useful, we have analysed complaints data submitted by suppliers to Ofgem to help estimate the utilisation of the cooling-off period.

Two respondents provided cooling-off implementation period costs. These costs included the one-off direct costs of amending IT systems to accommodate a cooling-off period. The estimated costs submitted to us ranged from around £95,000 to around £500,000.

One supplier stated a cooling-off period could increase costs associated with contract price hedging. They did not provide an estimate of what these impacts could be. We have conducted analysis of price hedging impacts in chapter four.

Several suppliers noted that an assessment needed to be made on how the cooling-off period would impact on the Switching Programme rollout. We have made amendments to the design of the cooling-off period to minimise interactions with the Switching Programme.

Broker commission transparency

Respondents provided implementation costs of providing broker commission on customer communications including the Principal Terms,⁷ bills and statements of account. These included one-off costs for changes to IT systems so that commission values would be displayed on each document. The estimated costs ranged from £370,000 to £500,000. One respondent did not provide an estimate of exact costs to make these changes but noted complex projects to change billing information can cost around £1.5M. We acknowledge this feedback and note the difference in estimated costs.

There may be reasons for the difference in costs submitted to us, for example the type of infrastructure different suppliers operate. However, we have made changes to our proposals so that brokerage costs need only be displayed on the Principal Terms document. This should minimise any system changes that stakeholders are required to make.

One respondent estimated IT and systems implementation costs of around £180,000 if commission is only displayed on the Principal Terms document. One respondent also included the estimated costs of printing and posting written communications to their customer base. These costs varied from around £16,000 to print and send a two-page letter to around £60,000 to print and send a four-page letter. We note this feedback. Our changes should not substantially increase the size or frequency of written documents sent to customers.

30-day contract extensions

One supplier estimated one-off IT system change costs to implement contract extensions of between £30,000 to £40,000. Several others suggested only a small number of contracts would be impacted by these changes – one supplier estimated 5% of their blocked microbusiness switches would benefit. Another supplier suggested these proposals would increase contract hedging costs; they did not provide detailed estimates of these costs.

⁷ The Principal Terms document includes key information about the customers' energy contract.

Notification requirements

We received little feedback to this proposal. Suppliers stated implementation costs would be low but did not provide detail.

Changes to the policy package

We have decided to amend our proposed policy package after reviewing feedback to the policy consultation and draft IA published in July 2020 and gathering additional evidence. The significant changes are to remove the BCP and informed contact choices provisions and contract extension proposals.

We acknowledge that there would be challenges associated with effectively implementing the BCP and Informed contract choices measures. We also recognise that since publishing our Policy Consultation, there has been an important development in the regulatory landscape concerning TPI regulation so we are accounting for this in our revised proposals.

In their December 2020 Energy White Paper, BEIS outlined their plans to ensure the retail market regulatory framework adequately covers the wider market. BEIS committed to consult on regulating third parties such as energy brokers, and we understand BEIS will shortly publish a Call for Evidence on consumer harms emanating from the activities of TPIs currently operating in the market. We welcome BEIS' commitment to take forward work in this area and view it as a positive step. We are sharing our evidence base with BEIS to help inform the development of plans for TPI regulation.

We are not pursuing the 30-day contract extension proposals after considering stakeholder views and evidence. We recognise that the benefits of this proposal would always be limited given that the time consumers spend on increased rates while issues with a blocked switch are resolved is also limited, with our proposed 30-day cut-off point reflecting this.

We have balanced this against the significant uncertainty in forecasting the cost to supply at the end of a contract and thus the potentially significantly higher risk premium that suppliers would likely pass on to consumers. We also recognise that requiring suppliers to apply the extension in certain cases such as where consumers are in debt or may have provided incorrect information appears inappropriate.

We have also amended the cooling-off provision to limit its application to certain periods during the switching process.

Where relevant, we explain below why these changes were made. A full explanation of why we are proposing these changes can be found in the accompanying statutory consultation.

A knock-on effect of the policy changes will be to remove several potential costs from the policy package. This includes implementation and monitoring costs associated with introducing the BCP and contract extension proposals. While we have decided not to quantify these costs, we believe they will reduce the cost impact of the policy package set out in the statutory consultation. For clarity, this IA will only assess the revised package of policy proposals set out in the statutory consultation and summarised below:

- **Provision of principal contractual terms:** Strengthening existing rules around the provision of principal contractual terms to ensure consumers receive this key information both pre and post-contract agreement in all cases. This will make sure microbusiness customers are aware of key pricing and other contract information.
- **Brokerage cost transparency:** Clarifying and strengthening existing supply licence obligations to provide information about brokerage costs on contractual documentation. This will provide microbusiness customers with information on how much they are paying for brokerage services so they can better judge if they are receiving value for money.
- **Broker dispute resolution:** Introducing a requirement for suppliers to only work with brokers signed up to an alternative dispute resolution scheme.
- **Cooling-off period:** Introducing a cooling-off period for microbusiness contracts for up to 28 days before supply start date. Microbusiness customers will have time to reflect on whether contractual terms meet their expectations.
- **Banning notification requirements:** Banning suppliers from requiring microbusinesses to provide notice of their intent to switch in the majority of scenarios
- **Information and Awareness:** Working collaboratively with Citizens Advice to create new and updated information so that microbusinesses can access up-to-

date guidance and advice alongside communications to help further boost awareness of how the market operates and their rights as consumers.

3. Impact Assessment approach

This section explains the purpose of the impact assessment. We also explain our approach to the impact assessment including the use of quantitative and qualitative data, and impact on different customer types.

IA purpose

This IA makes an evidence-based assessment of the policy package we are proposing to tackle issues microbusinesses are facing in the non-domestic market. It aims to identify the impacts, costs and benefits of our proposals and highlight why they will make improvements to the existing arrangements.

A quantitative assessment of the benefits and costs of the proposals is included where possible. Where quantitative analysis has not been possible, the IA includes qualitative analysis and sets out the potential costs and benefits of the policy options we aim to put in place.

Our interventions focus on making sure microbusinesses receive appropriate protection and customer service and can easily navigate and access competitive offerings to make informed decisions. We have used a customer journey model as a guide to make sure our objectives are being met.⁸

⁸ The Customer Journey Model outlines a set of practical principles we think should apply at each stage of microbusinesses journey through the energy market. A copy of the model is available on page 3 of the Opening statement – Strategic Review of the microbusiness retail market (Ofgem), <https://www.ofgem.gov.uk/publications-and-updates/opening-statement-strategic-review-microbusiness-retail-market>

Quantitative and qualitative data

Where possible we have undertaken a quantitative assessment of the impacts. For example, we have estimated the financial cost of implementing a broker ADR scheme.

For some areas of the analysis, quantification of impacts was not possible; either because the impacts are intangible, difficult to measure, or adequate data was not available. Where this was the case, we focused on the expected impact in qualitative terms.

Such an approach is consistent with best practice guidance. We have used evidence gathered in response to the Microbusiness Strategic Review Call for Inputs, Policy Consultation and Draft Impact Assessment to inform our thinking on the qualitative impacts.

Baseline and alternative case

Our baseline case for the IA is the *Do-Nothing* approach. Under this option, we would not intervene in the microbusiness supply market. This would leave the market to operate as it currently does. No changes would be made to electricity or gas supply licences. Microbusiness suppliers would still be subject to the existing microbusiness provisions set out in the supply licences.

We do not believe this option is appropriate given the challenges we have identified microbusinesses face in the market. The policy consultation document published in July 2020 sets out in detail what these challenges are. The strength of evidence we have found suggests that changes are required to ensure good practice across the microbusiness energy supply market and that all consumers have trust in suppliers and TPIs they engage with. As such, we believe regulatory intervention is required to create a more transparent and efficient market and improved consumer experience.

Our alternative option is the proposed package of policy measures we are consulting on.

These measures are explained in chapter one. We have used evidence submitted in response to the draft IA to help us identify the financial and monetary impacts of these

proposals. We have also used evidence submitted to the policy consultation and call for inputs to help us identify how stakeholders may be impacted by the proposals.

Different stakeholder groups

We consider the impacts of the proposals on different stakeholder groups. These are microbusiness customers, microbusiness energy suppliers, and TPIs.

We consider the impact on larger and smaller microbusinesses. We consider that smaller microbusinesses tend to be more disengaged and less well-resourced than larger microbusinesses. Contractual and pricing data we collect confirms that around 63% of smaller microbusinesses⁹ are on a negotiated contract compared to around 83% of all other microbusinesses.

⁹ Smaller microbusiness is defined as consuming less than 5MWh and 15MWh of electricity and gas respectively each year.

4. Assessment of benefits

We set out the benefits of our proposed policy changes. These are more transparent brokerage costs, implementing a broker dispute resolution scheme, making the switching process more efficient, and being able to cool-off from an inappropriate deal.

In this section, we discuss the benefits of implementing our proposed package of policy changes to the microbusiness supply market. We briefly describe each benefit, the issues with the current regime, and quantified or qualitative benefits the changes will create.

Benefit one: Clearer brokerage costs

Description

Currently suppliers must take 'all reasonable steps' to bring the Principal Terms of a contract, in plain and intelligible language, to the attention of a microbusiness customer before entering into a contract.¹⁰ We propose strengthening the requirements around Principal Terms to ensure that they are provided to customers in all cases. This will ensure that consumers always receive key information about a new contract, including any brokerage costs, which we believe is an essential part of a robust contracting process.

In addition, we are proposing to further clarify when the *written* Principal Terms must be provided. We propose amending the existing obligation to require that a written copy of the Principal Terms must be sent to the customer no later than one working day after a contract has been entered into.

¹⁰ The Principal Terms contain the key terms of a contract. A full definition of what is included in the Principal Terms is available within the Electricity Supply Licences, <https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions>

We have decided not to proceed with the additional requirements for suppliers to disclose the charges paid to brokers as part of the supply contract on bills and account statements. Microbusiness customers are likely to gain most benefit from obtaining information about brokerage costs at the point when they are considering entering into a new contract. By the time a consumer receives bills and statements of account they will typically have made their purchasing decision and any cooling-off period will have expired. Receiving this information on these communications will be of limited value.

Non-quantified benefit

Our proposal will provide transparency around brokerage costs for microbusiness customers allowing them to make better informed contract choices. These are non-quantified benefits for the reasons below.

The proposals will allow microbusiness consumers to make better choices about which brokers they engage with and energy contracts they sign up to. It is difficult to quantify or monetise these precise impacts. Our proposals will make sure that microbusinesses know how much they are paying in brokerage costs. This will allow them to make a more informed decision about whether that broker is delivering value for money in terms of the service it provides. This does not necessarily mean that paying what appears to be relatively high brokerage costs will be avoided by customers – brokers may deliver services to customers that justify the amount levied.

We consider including brokerage cost amounts within Principal Terms will help microbusinesses avoid paying unjustifiably high brokerage costs. It will be much easier for microbusinesses to understand how much they are paying for brokerage services. This will allow them to better evaluate the value of the service provided. That will allow them to make a more informed choice on whether the best value deal has been secured for them and if the broker should be reengaged for future deals.

The proposal should have a minimal impact on suppliers. As stated above, we are strengthening the requirements around Principal Terms to ensure that they are provided to customers in all cases and clarifying when written terms must be sent. This will remove any ambiguity about providing this information to customers and ensure consistency.

We have removed requirements in earlier policy proposals to publish brokerage costs on customer bills and statements of accounts. These proposals would have required suppliers to incur costs to make sure brokerage costs were accurately explained in these documents.

Based on estimates submitted to the Draft IA these costs could have run into millions of pounds across the supplier sector. Our decision to limit the display of brokerage cost to only the Principal Terms avoids these costs. The proposal should also have a minimal impact on brokers. Most brokers provide a good service to microbusinesses and should be able to justify the amount they charge for their services. Knowing and recording costs should be standard practice across brokers and suppliers so the additional cost of ensuring information about those costs are provided to customers should be minimal.

In the current market, brokerage costs are typically bundled within wider energy costs. This is creating an information asymmetry which is causing some microbusinesses to overpay for broker services.¹¹ Maximising the opportunities for customers to make more informed contract choices will reduce the risks they overpay and allow competition to be more effective.

Benefit two: Broker dispute resolution mechanism

Description

A microbusiness who has a dispute with their supplier that they cannot resolve through the supplier's complaints handling process can seek independent redress with the Alternative Dispute Resolution (ADR) scheme operated by Ombudsman Services. However, there is no mandated route available to microbusinesses allowing them to pursue independent redress with their broker.

To amend this protection gap, we propose creating a supply licence condition requiring suppliers to only work with brokers signed up to an ADR scheme. This would allow microbusinesses to raise a complaint to the ADR provider if they cannot resolve a dispute directly with their broker.

¹¹ The MBSR Policy Consultation published in July 2020 sets out examples.
<https://www.ofgem.gov.uk/publications-and-updates/microbusiness-strategic-review-policy-consultation>

The proposed licence conditions will set out high level requirements for an ADR scheme. The scheme provider(s) will set out detailed scheme arrangements and requirements in their terms of reference.

Non-quantified benefit

We consider there are two benefits created by our proposal. Firstly, microbusinesses will be provided with a third party to resolve broker complaints who can make sure they get redress where appropriate. This will increase trust and confidence in the market. The ADR scheme will also be a source of industry information on broker issues for the regulator and suppliers.

Several respondents to the draft IA suggested there may be low level of customer complaints about broker activities. We reviewed complaints data submitted to us by suppliers to confirm the known number of complaints about third party sales activities made known to the supplies.¹² This data suggests that in 2019 suppliers were receiving an average of around 1000 complaints about third party sales per month. This was around 6% of the total complaints made to suppliers.

Based on our analysis of the complaints data, we consider that an ADR scheme will receive a volume of complaints about brokers that justifies its existence. We also consider the creation of a scheme will likely lead to additional microbusinesses raising disputes about broker performance. Our proposals to improve microbusiness customers' awareness of their regulatory protections should also increase these numbers. Awareness and utilisation of the ADR scheme could help improve broker standards by imposing a direct cost on poor conduct.

Suppliers should also benefit from the implementation of an ADR scheme. At present, microbusinesses who have concerns about third party sales may approach the supplier for help or a resolution. Our proposals should reduce this administrative burden on suppliers – complaints about brokers can be directed to the ADR provider.

¹² Ofgem, Supplier complaints data, <https://www.ofgem.gov.uk/consumers/energy-supplier-comparison-data/compare-supplier-performance-complaints>

The ADR scheme(s) will also generate information on the complaints they deal with. This includes the volume of complaints, parties involved, and outcomes. We expect the ADR provider(s) will also maintain a list of brokers subject to their scheme.

This data may provide additional information to the regulator and microbusiness customer representatives on the types of issues microbusiness customers face when dealing with brokers. This will allow us to better monitor the market and identify where there are areas of concern or poor practice.

Benefit three: More efficient contracting and switching processes

Description

Cooling-off period

We propose changes to make contracting and switching processes more efficient: these are introducing a 14-day cooling-off period for microbusiness energy contracts and prohibiting suppliers from requiring microbusinesses to provide notice of termination when leaving an energy contract.

We propose to introduce a mandatory 14-day cooling-off period for microbusiness energy customers. Our original cooling-off period proposals would have given microbusinesses the right to cancel a contract by giving notice to the supplier 14 days after the date they have entered into the contract and had been provided with the Principal Terms in writing. As explained in the statutory consultation, we have amended this so that the 14-day cooling-off period is only required up to 28 days before the supply start date (the first point when a new switch can be registered). For example, in the case of a customer who enters into a contract 38 days ahead of the date on which supply under the terms of that contract is due to begin, the cooling-off period will end 28 days before the date on which supply under the terms of that contract is due to begin. It would therefore last 10 (rather than 14) calendar days from when the contract is entered into. This will avoid the cooling-off period interacting with changes being made through our Switching Programme.

Termination Notice

Currently suppliers are permitted to require notice of termination from microbusinesses with a notice period of up to 30 days. We propose to remove this so that suppliers will not be permitted to require microbusinesses to provide notice of their intent to switch.

Quantified and non-quantified benefits

Our proposals will create several benefits for microbusiness customers. These are the ability to opt out of inappropriate contracts during the cooling-off period and simplifying the switching process. The cooling-off period will help microbusinesses avoid costs of being on inappropriate contracts. Microbusinesses can utilise the cooling-off period to find alternative and better value fixed term contracts.

We have estimated the financial benefit this could create for microbusinesses based on data submitted to us by the largest suppliers.¹³ Our analysis is based on the number of electricity and gas acquisition and retention contracts agreed by these suppliers in 2019 which were entered into more than 28 days ahead of the date on which supply is due to start and so would have been eligible for a cooling-off period under our revised proposal.

We have used the proportion of domestic consumers who cool-off as a proxy for the proportion of microbusinesses who will likely cool-off. To estimate the proportion of domestic consumers who exercise their cooling-off rights we have used industry data on switch cancellations and compared the proportion of switches which are cancelled at a customer's request between domestic and non-domestic consumers.¹⁴ We consider that the higher rates for domestic cancellations at a customer's request is due to the existence of cooling-off rights for domestic customers and a similar proportion of microbusiness consumers would cool-off if they had similar rights. This gives us an estimated proportion of microbusiness customers who may benefit from these arrangements as 5.5% and 5.2%

¹³ A Request for Information (RFI) was issued to the suppliers from whom we regularly collect contractual and pricing data. These suppliers represent approximately 90% of the small business market segment. These are British Gas, CNG Ltd, Corona Energy, E.ON, EDF, Gazprom Energy, npower, Drax (Opus Energy and Haven power), SSE, Scottish Power and Total Gas & Power.

¹⁴ We receive monthly data on the number of switch cancellations from DNOs for electricity and Xoserve for gas. In our analysis of the proportion of non-domestic switches cancelled at a customer's request we use the number of electricity switch cancellations for Profile Classes 3 and 4 consumers (as these more closely reflect microbusiness consumers) and the number of gas switch cancellations for all non-domestic consumers.

for electricity and gas respectively. We therefore estimate that roughly 21,700 microbusiness consumers will cool-off from electricity contracts and 6,700 from gas contracts each year.

We acknowledge views and evidence submitted to us from suppliers suggesting there may be a low uptake of cooling-off periods. However, we consider that implementing cooling-off rights (which also includes for contracts agreed via brokers) alongside our other proposals to increase the transparency of brokerage costs and provide written Principal Terms, as well as greater awareness of microbusiness protections, will increase the number of customers using a cooling-off period.

We consider that consumers may cool-off for a variety of reasons such as inadvertently agreeing to a deal over the phone. This makes it difficult to estimate the average benefit to a consumer in each incidence of cooling-off. Evidence submitted to us suggests that in some cases microbusinesses have signed up to deals including tens of thousands of pounds of brokerage costs. The cooling-off period will give microbusiness customers the opportunity to fully consider deals they have agreed and make better informed contract choices.

In the absence of alternative data, we have assumed that consumers who cool-off would achieve a price saving as they move to a lower cost contract. If these consumers move from retention deals to acquisition deals, then there would be an annual benefit of £2.05m. If these consumers moved from the upper quartile to the median of negotiated contract prices then there would be an annual benefit of £5.2M.^{15, 16} However, we believe that this figure could be much higher given the severity of some cases.¹⁷ We therefore estimate that the cooling-off period would create at least £2.05M of benefit per year to microbusinesses through avoiding overly costly deals.

¹⁵ An acquisition contract is a customer's first fixed term contract with a supplier. A retention contract is a new fixed term contract agreed with an existing customer at the end of, or following the expiry of, a fixed term period. Negotiated contracts include both acquisition and retention contracts.

¹⁶ Our analysis of contractual and pricing data suggests that the differential between mean acquisition and retention contract prices is 1.9% and 0.2% for electricity and gas respectively and that the differential between the upper quartile and median of different suppliers' mean negotiated contract prices is 4.1% and 4.3% for electricity and gas respectively. For a microbusiness consumer with average consumption this equates to monetary savings over the length of a two year contract ranging from £85-£180 for electricity and £6-£116 for gas.

¹⁷ Our Policy Consultation summarises examples of microbusiness customer overpayments. Ofgem, Microbusiness Strategic Review: Policy Consultation, <https://www.ofgem.gov.uk/publications-and-updates/microbusiness-strategic-review-policy-consultation>

Termination Notices: Removing the option to require customers to submit a termination notice will help microbusinesses avoid the costs of being put on costly out-of-contract rates where a switch is blocked because a termination notice has not been provided. Data submitted to our contractual and pricing microbusiness RFI suggests there is a large difference in costs between negotiated and out-of-contract rates. On average, the unit revenue for out-of-contract rates is around 51% higher than a negotiated contract for electricity contracts and 74% for gas contracts. While microbusinesses may only be placed on these rates temporarily, it means they pay significantly more for energy than they were anticipating.

For a microbusiness with average annual consumption this equates to an increased cost per month of approximately £82 and £74 for their electricity and gas supply respectively. While we consider that consumers who have attempted to switch are more likely to be engaged and subsequently attempt to switch again (or agree a contract with their existing supplier) there is a risk that some do not and spend significant periods of time on these higher rates. Data from our contractual and pricing microbusiness RFI indicates that, on average, meter points remain on default tariffs for over 3 years.

It is difficult to accurately determine the number of microbusinesses who have a switch blocked solely because of failure to comply with termination notice procedures as switches may be objected to multiple times and there may be multiple reasons for an objection. For example, a switch could be blocked on the grounds of insufficient notice, but the consumer also has an outstanding debt. The supplier may then raise an objection to any further switches due to the outstanding debt. A sample of supplier objections obtained during our 2016 review of non-domestic objections found that 15% of microbusiness objections were due to issues with termination notice procedures.¹⁸ Given that in February 2021 alone there were over 14,000 objections for electricity profile class 3 and 4 consumers we consider it likely that thousands of microbusiness consumers would benefit from the removal of termination notices each year.¹⁹

¹⁸ More detail on our 2016 review of non-domestic objections can be found at: Ofgem, Decision on review of domestic and non-domestic objections, <https://www.ofgem.gov.uk/publications-and-updates/decision-review-domestic-and-non-domestic-objections>

¹⁹ We receive monthly data on the number of electricity switch cancellations from DNOs.

30-day contract extensions

We have decided not to proceed with the proposal for 30-day contract extensions. The aim of this proposal was to prevent engaged customers from being disadvantaged by facing increased charges while an issue with their switch is resolved. The proposal would limit the financial impact of customers being temporarily placed on out-of-contract rates.

We consider that the benefits of this proposal would be limited. Respondents to the draft IA considered only a small number of microbusiness customers would be impacted by the change – one respondent considered only 5% of blocked switches would be affected by this proposal. We also recognise that the time consumers spend on increased rates while issues with a blocked switch are resolved is limited, with our proposed 30-day cut-off point reflecting this.

Implementing the proposal would also create uncertainty in forecasting the cost to supply at the end of a contract. This could lead to significantly higher risk premiums that suppliers would likely pass on to consumers. We also recognise that requiring suppliers to apply the extension in certain cases such as where consumers are in debt or may have provided incorrect information appears inappropriate.

5. Assessment of costs

We set out the costs of our proposed policy changes. These are costs related to implementing the proposals, impact on supplier hedging strategies and ADR scheme costs.

In this section, we discuss the identified costs of our policy proposals package in the microbusiness supply market.

Cost one: implementation costs

Description

Suppliers will incur some costs implementing our proposed policy package. These relate to costs to implement the brokerage cost transparency proposal, cooling-off period, and removal of the termination notification requirements. We consider ADR costs in a separate section below.

The revised policy package will have much lower implementation costs than the proposals contained in the policy consultation published in July 2020. Our decision to remove the broker conduct principle and informed contract choices proposals have removed significant potential system change, implementation, and broker monitoring costs from the policy package.

We have also made changes to the application of the cooling-off period to avoid interactions with the Switching Programme. This has also removed substantial potential costs.

Quantified and non-quantified costs

Our proposals may incur costs related to implementing a cooling-off period, requirements concerning the communication of Principal Terms and removing the termination notice. As discussed above, suppliers submitted estimated implementation and monitoring costs for the broker conduct principle and informed contract choices in response to our draft IA. Industry-wide these costs were estimated to run into millions of pounds. Our decision to

remove the broker conduct principle and informed contract choices also means additional costs associated with both proposals will be avoided.

Suppliers submitted estimated costs for implementing the brokerage cost transparency proposals. These estimated costs were mostly based on including brokerage costs in a range of documents including bills and statement of account. The estimated system change costs ranged from a low of £370,000 to a high of £500,000.

We have revised this proposal so that brokerage costs need only be displayed on the Principal Terms statement. We consider the existing obligations in the supply licence already require brokerage costs to be included in the Principal Terms. One supplier estimated one-off IT system change costs to include brokerage costs in the Principal Terms of around £180,000. While this is very limited feedback, we consider this estimate suggests any costs suppliers must incur would be significantly lower than for our original proposals.

Concerns were raised about proposals to implement a 14-day cooling-off period described in the policy consultation. Respondents to both the policy consultation and draft IA were concerned about how implementing a cooling-off period would interact with planned system changes to implement the Switching Programme. Respondents suggested delays may occur to the Switching Programme or more costly system changes would be required to implement a cooling-off period.

We are proposing amending the timing of the cooling-off period to avoid any interaction with Switching Programme changes. The cooling-off period will only be required up to 28 days before the supply start date. This change should avoid any costly impacts associated with an overlap with the Switching Programme.

We requested data from the largest suppliers on estimated initial implementation costs for a mandatory cooling-off period.²⁰ Our data request asked the suppliers to estimate these costs assuming 56 day and 180-day implementation timelines.²¹

²⁰ A Request for Information (RFI) was issued to the suppliers from whom we regularly collect contractual and pricing data. These suppliers represent approximately 90% of the small business market segment. These are British Gas, CNG Ltd, Corona Energy, E.ON, EDF, Gazprom Energy, npower, Drax (Opus Energy and Haven power), SSE, Scottish Power and Total Gas & Power.

²¹ The 56 day implementation period is based on the requisite stand-still period before licence condition changes come into effect after any decision we may make. The 180 day implementation period also includes a period of time for stakeholders to further prepare for the proposed changes.

Cost estimates for implementing the cooling-off period with a 56-day timeline ranged from £100,000 to around £1.4M. They totaled £4.1 million across the group of suppliers, however three suppliers stated that they would not be able to implement the proposal in the 56-day timeline and so did not provide a figure. Suppliers estimated a wider cost range for implementing the cooling-off period with a 180-day timeline; this ranged from £60,000 to around £1.4M. They totaled £4.3 million across the group of suppliers.

Suppliers did not provide a detailed breakdown of how these implementation costs were calculated, however we understand they will include changes to existing IT systems and processes. Differences between the estimates submitted by suppliers may be accounted for by the size of supplier, their existing customer base, the IT system they operate and other factors unique to individual suppliers.

We acknowledge that suppliers will need to incur costs to implement the cooling-off period. However, these implementation costs should be viewed against the continuing benefit a cooling-off period will bring to microbusiness customers we calculated in chapter four.

We consider our proposal to remove termination notice requirements will have minimal cost impact on suppliers. The feedback we did receive from suppliers considered this was a low impact and cost change.

Cost two: impact on hedging strategies

Description

We understand that in the non-domestic market many of the available contract prices closely reflect wholesale market prices at that time. Due to this, some suppliers have told us that they immediately hedge the volume of energy estimated to be required for non-domestic contracts at the point the contract is agreed to limit exposure to a change in wholesale prices.

Concerns were raised about the impact a 14-day cooling-off period could have on these supplier price hedging strategies. Some suppliers considered they would need to factor in the possibility that microbusiness customers may utilise the cooling-off period to exit a contract after the supplier has purchased the energy required to fulfil that contract on the wholesale markets.

We consider that the cost impact of consumers cooling-off for any other reason than a change in wholesale prices (such as where a customer has unwittingly signed up to a deal over the phone) should be negligible as these events are just as likely to occur following a decrease as they are an increase in wholesale market prices.²² Therefore we would expect the effects of losses and gains on a supplier's hedged position because of these events to balance out.

We have undertaken further analysis estimating what financial impact could arise from microbusiness consumers using the cooling-off period in response to a change in wholesale prices. If consumers were more likely to cool-off after wholesale prices decrease, then suppliers would be at an increased risk of making a loss when selling the purchased energy back to the market.

This analysis calculated the overall cost to consumers, caused by the impact of a cooling-off period on hedging strategies, by applying a risk premium to the price of all microbusiness contracts. The risk premium is the premium on contract prices that suppliers will include to account for additional costs being incurred when a customer cools-off. Further detail on this analysis can be found within Appendix 1.

Quantified costs

We consider the cooling-off period will have a low-price impact on supplier hedging strategies and microbusiness customer bills.

We have estimated the cost impact the cooling-off period could have on individual microbusiness contracts and across the sector based on two scenarios of consumer behaviour in response to a cooling-off period (a higher and lower case informed by the micro and small business segmentation identified in our 2018 Micro and Small Business Engagement Survey).²³ In our lower-case scenario, a smaller proportion of consumers cool-

²² Analysis of season +2 and season +2 wholesale prices over 2017- 2020 found that electricity prices decreased compared to 14 days prior in 51% of occasions and increased in 49% of occasions. Gas prices decreased in 54% of occasions and increased in 46% of occasions.

²³ Ofgem, Micro and Small Business Engagement Survey 2018, <https://www.ofgem.gov.uk/publications-and-updates/micro-and-small-business-engagement-survey-2018>

off in response to a decrease in available contract prices (due to a drop in wholesale prices) and a higher proportion do so in our higher scenario.

In our lower case, we estimate that the cooling-off period may have an annual cost impact of £132,000 across all fixed-term microbusiness contracts. This equates to roughly £0.04 on an average microbusiness electricity bill and £0.22 on an average gas bill.

In our higher case, we estimate that the cooling-off period may have an annual cost impact of £1M across all fixed-term microbusiness contracts. This equates to roughly £0.54 on an average microbusiness electricity bill and £1.20 on an average gas bill.

In practice we expect that suppliers will be able to reduce their exposure by altering their purchasing and pricing strategies. For example, by waiting to purchase a proportion of the energy required until after the cooling-off period has expired. We are conscious that some suppliers may already do this for a number of their contracts as many suppliers issue price books for brokers and TPIS to use with these prices being updated every few weeks.

Cost three: Broker ADR scheme costs

Description

Our proposals will require suppliers to work only with brokers signed up to an ADR scheme. This means brokers will need to join a qualifying dispute resolution scheme operated by an ADR provider to access energy contracts provided by suppliers.

There are no existing ADR schemes for brokers in the microbusiness retail market. Below we estimate the potential costs that could be associated with such a scheme.

We are unable to be specific about some of these costs. The exact amount will depend upon the nature and scope of the scheme(s) set up by ADR providers. Where we have not been able to provide figures, we have flagged where we expect costs to be incurred by brokers.

Quantified costs

A broker ADR scheme will need to recover costs associated with setting up the scheme, ongoing fixed running costs, and ongoing variable running costs.

A broker ADR provider will need to recover scheme set up costs. These costs will include creating the scheme's rules and documentation, IT system costs, broker onboarding costs, recruitment, training, and awareness raising. We anticipate recovering set up costs should form part of annual subscription costs and should take no longer than a three-year period to fully recover.

Fixed running costs will include costs associated with broker relationship and support services, oversight, and compliance with scheme rules, and maintaining the scheme and broker register. We anticipate these will be annual costs recovered on an ongoing basis from brokers.

A scheme provider will also need to recover the variable costs of case investigations. These costs will be recovered through case fees paid by brokers and may form the largest cost component they pay to the scheme.

Fees paid by brokers to an ADR scheme will depend upon a number of factors including the costs required to administer the scheme, the number of brokers who are required to pay subscriptions, and the number of cases submitted to the scheme. Rules associated with a scheme, and broker performance will determine the exact level of these costs and fees.

Below are illustrative examples of the range of costs and fees that may be recovered through a broker ADR scheme. This information has been provided by Ombudsman Services, reflecting their thoughts on the potential costings for the scheme drawing on their experience of providing existing ADR services and making a number of assumptions around the broker market. For clarity, they are not indicative of actual costs or fees brokers may pay in any future ADR scheme.

Table 1: example of ADR scheme set up and running costs in years 1 to 3

	Set up costs (pa years 1-3)	Fixed running costs pa	Total scheme fixed costs pa	Annual subs per member – based on 1,500 members	Annual subs per member – based on 2,000 members
Low Estimate	£145,000	£400,000	£545,000	£365	£275
High Estimate	£185,000	£485,000	£670,000	£445	£335

The illustrative example contains low and high estimates of total scheme fixed costs of £545,000 and £670,000 pa respectively in the first three years. These costs would be recovered through an annual subscription paid by brokers. The number of brokers required to pay the subscription will determine the fee amount: in our example annual subscriptions for 1500 brokers would be £365 and £445 for the low and high estimates respectively. The table below shows illustrative case fees brokers may need to pay if complaints are submitted to the ADR scheme by microbusiness customers. We have provided low and high examples of broker case fee. Total fees paid by brokers will depend on their performance; the lower the number of complaints the scheme receives, the lower the cost to the broker.

Table 2: illustrative case fees

	Case fee	10 cases per annum	50 cases per annum	100 cases per annum
Low Estimate	£340	£3,400	£17,000	£34,000
High Estimate	£400	£4,000	£20,000	£40,000

We have assumed case fees of £340 and £400.²⁴ The impact of case fees on brokers will depend on how many complaints about their service or performance are submitted to the ADR scheme. There should be a strong driver to minimise how many complaints are made to the scheme by delivering good customer service.

²⁴ Based on cost estimates from Ombudsman.

6. Other impacts

This chapter discusses environmental and competition impacts the proposals could have. We also consider what impact the Covid-19 pandemic could have on implementing our policy package.

Environmental impacts

Our policy package will have limited environmental impacts. It will not substantially change the amount of electricity or gas contracts agreed between microbusinesses and suppliers, or the amount of energy consumed. The impact on energy demand should be limited. There may be a small increase in energy demand as microbusinesses face an overall lower cost of energy due to the brokerage cost transparency and cooling-off period proposals allowing them to identify and cancel overly costly deals and subsequently direct the money saved into additional energy usage . However, we consider this impact will be minimal.

On that basis, we consider the environmental impacts from the changes will be negligible.

Competition impacts

The proposals should improve competition in the microbusiness retail market. Brokerage cost pricing will be more transparent. This will allow customers to make more informed choices about the energy contracts offered to them. Microbusiness customers should be able to better identify good value deals that meet their needs. This will encourage both TPIs and suppliers to make sure they are providing a better-quality service and recommending appropriate contracts to customers.

The cooling-off period will also allow customers to cancel contracts where they have unwittingly signed up to deals over the phone (ie without realising that they are signing up to a legally binding contract), or where, on reflection, microbusinesses are feeling as though they have been misinformed or not provided with complete information.

These customers will be able to reengage with the market to find a more appropriate contract. This will also encourage suppliers and TPIs to make sure they are providing good service to customers and contracts that are appropriately priced.

We do not consider the proposals will unfairly impact on competition between suppliers' direct sales and brokered sales for microbusiness energy customers. TPIs are becoming an increasingly important route to secure energy deals for microbusiness customers. The proposals should not hinder or impact on TPIs' ability to procure energy contracts for customers so far as they are providing a value for money service.

Confidence in using TPIs may improve because of our proposals by improving transparency and providing microbusiness customers with a mechanism to resolve complaints about poor service that cannot be resolved directly. These changes will impact poorly performing TPIs; limiting their ability to operate may reduce any negative views about TPIs in general. This will allow TPIs to better compete for microbusiness energy customers.

Covid-19 impacts

We recognise that a well-functioning market will be more important than ever as many microbusinesses emerge from the challenges posed by the Covid-19 pandemic.

Our policy measures will contribute to the longer-term recovery by improving microbusiness experience at each stage of their customer journey. We consider each measure to be proportionate and one that can realistically be implemented by suppliers and other industry participants who are also working hard to recover and rebound from the pandemic.

Monitoring risks and impact

In our view, the policy package will deliver net positive benefits for microbusiness customers. However, we intend to monitor the impact the measures are having on the microbusiness retail market; this will help us determine their effectiveness or if any unintended effects have been created.

We are developing our thinking on the most effective way to measure the policy package's impact. Areas we are considering monitoring include the utilisation of the cooling-off period and uptake of the broker ADR scheme.

We will engage with relevant stakeholders as we develop our monitoring proposals. We will also be happy to engage with stakeholders about any issues they wish to raise about proposals once they are in operation.

7. Assessment summary

This chapter summarises the benefits and costs explained in previous chapters. On balance, we consider the benefits to implementing the proposals will comfortably outweigh the costs.

Benefits summary

Our benefits analysis is partly non-quantifiable. We have used evidence collected through our consultation activities to inform our views on the benefits our policy package will bring and their magnitude. We have been cautious in not making unrealistic assumptions about how microbusiness consumers will be impacted by our proposals.

We consider the package will create meaningful benefits for microbusiness consumers. The changes will improve market transparency and allow customers to better identify appropriate energy contracts.

Customers will gain access to improved protections. Complaints about broker performance can be referred to an independent dispute resolution scheme. A cooling-off period will also give microbusiness customers the opportunity to not take up contracts where they have signed up to deals over the phone without realising that they are signing up to a legally binding contract, or where on reflection microbusinesses are feeling as though they have been misinformed or provided with incomplete information.

We have quantified how much microbusinesses may benefit by being able to use the cooling-off period to cancel overly costly contracts. Our analysis calculates the cooling-off period could deliver at least £2.05M of benefits to microbusinesses each year. This is based on microbusinesses using the cooling-off period to move from retention deals to acquisition deals. We have also calculated that microbusiness customers could create a benefit of £5.2M if they use the cooling-off period to move from the upper quartile to the median of negotiated contract prices.

Removing the requirement to submit a termination notice will help microbusinesses avoid the costs of being put on out-of-contract or default tariff rates. We calculate our proposals will mean microbusinesses whose contract switch may have been blocked will avoid the

costs of being put onto out of contract rates. These avoided costs are approximately £82 and £74 for electricity and gas supply per month respectively.

Analysis of supplier objections data suggests that 15% of microbusiness objections were due to issues with termination notice procedures. On this basis, we consider it likely that thousands of microbusiness consumers will benefit from the removal of termination notices each year.

Together these proposals will improve existing market arrangements. We believe maintaining existing market arrangements is not a credible option to go forward with.

We have considered how the proposals will benefit microbusinesses by size. It is likely that smaller microbusinesses will gain more benefit from many parts of the package compared to larger microbusinesses. Smaller microbusinesses are likely to have fewer resources to search for or negotiate an energy deal. This increases the risk they are mis-sold a deal or receive poorer customer service.

Costs summary

A range of quantified and monetised data was collected from stakeholders on the costs associated with the policy package. These are summarised below.

Cost one: implementation costs

Stakeholders estimated implementation costs to display brokerage costs on customer documentation of between £370,000 to £1.5M. Changes to our policy proposals so that brokerage costs are only required to be included in Principal Terms should avoid most of these costs.

There was significant cost variation for implementing the cooling-off period with either a 56 day or 180-day implementation period. Differences in the size of supplier or how suppliers operate their systems may partly explain this difference. Suppliers may also have used different methodologies to calculate the costs impact. However, across the largest microbusiness suppliers, the total cost to implement the cooling-off period with a 180-day timeline was around £4.3 million. To implement with a 56-day timeline was around £4.1 million, however fewer suppliers provided an estimate as they considered it would not be possible to implement the proposal in this time scale.

These are largely one-off implementation costs. We consider the ongoing benefit microbusiness will gain through access to a cooling-off period – which we estimate as at least £2.05 million per annum – will over time outweigh the implementation costs.²⁵ On that basis, we consider the costs can be justified when set against the long-term benefits a cooling-off period will create for customers.

Cost two: impact on hedging strategies

Analysis suggests that the impact of incorporating a risk premium into hedging strategies to take account of the cooling-off period should be low.

In the lower-case analysis, the cooling-off period may have an annual cost impact of £132,000 across all fixed-term microbusiness contracts. This equates to roughly £0.04 on an average microbusiness electricity bill and £0.22 on an average gas bill. The higher case analysis estimates an annual cost impact of £1M across all fixed-term microbusiness contracts. This equates to roughly £0.54 on an average microbusiness electricity bill and £1.20 on an average gas bill.

This impact will be relatively minor for microbusiness customer bills. It's also likely that this cost impact will be reduced further by suppliers amending their hedging strategies. This cost will also be offset for microbusiness customers as they will have the ability to use a cooling-off period to get out of inappropriate or unjustifiably high cost contracts.

Cost three: Broker ADR scheme

Illustrative examples of ADR schemes have been provided in the IA. These examples suggest high and low estimates of total scheme fixed costs of around £670,000 and £545,000 pa respectively in the first three years of the scheme. These costs would be recovered through an annual subscription paid by brokers. Recovering these costs through brokers would lead to annual fees of £445 and £365 for the high and low estimates respectively.²⁶

²⁵ We estimate that the cooling-off period proposal would pay back these £4.3M implementation costs in a maximum of 4.5 years based on the £2.05M annual benefit less the £1M annual cost impact on hedging strategies discounted with the 3.5% Social Time Preference Rate.

²⁶ Based on 1500 joining the ADR scheme.

We consider costs comparable to these would not be excessive compared to existing customer dispute resolution schemes. They are also justified based on evidence of consumer harm caused by a minority of brokers engaging in poor practice typically leading to the agreement of overly costly supply contracts.

8. Appendices

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Appendix 1 – Analysis of cooling-off period risk premium

We outline below our analysis for estimating the risk premium on the wholesale energy component of a microbusiness gas or electricity contract and the subsequent increase in annual contract costs that could become relevant due to a 14-day cooling-off period.

The risk premium is the additional premium that could be included in this component to account for the risk of losses incurred by customers exercising their rights to cool-off.

This calculation is an estimation of the impact across the market. Individual suppliers are likely to account for cooling-off periods in different ways due to differing hedging strategies, risk appetites and other factors.

Key Assumptions

- When contracting with a customer who is entitled to a cooling-off period the supplier immediately procures the expected energy required for the first year of that contract.
- Suppliers can use the energy procured for other demand and thus avoid incurring transaction costs twice. Transaction costs are therefore ignored.
- On average wholesale prices are equally likely to increase and decrease and by the same magnitude. Therefore, in the long run, the effects from consumers cooling-off due to reasons not influenced by wholesale price movement balance out.²⁷
- Changes in wholesale prices are fully passed through to consumer contract prices.

Analysis

The calculation estimates the risk of mark-to-market losses on the purchased energy that would occur due to an increased proportion of customers cooling-off due to a decrease in wholesale prices.

²⁷ Analysis of season +2 and season +2 wholesale prices over 2017- 2020 found that electricity prices decreased compared to 14 days prior in 51% of occasions and increased in 49% of occasions. Gas prices decreased in 54% of occasions and increased in 46% of occasions.

Risk of making a loss on a sale due to a consumer cooling-off in response to a decrease in wholesale prices

=

Proportion of sales where customer cools off in response to price fall x Mean wholesale price decrease when customers have cooled-off

Given the uncertainty and difficulty in predicting consumer behaviour we have used two potential scenarios of consumer behaviour in our analysis, one which assumes a higher proportion of consumers cool-off in response to a drop in wholesale market prices and one which assumes a lower proportion of consumers cool-off in response to wholesale price drops.

In both scenarios we utilise the customer segmentation from our 2018 Micro and Small Business Engagement Survey to estimate the proportion of consumers who would be motivated to switch by a drop in available contract prices following a decrease in wholesale prices.²⁸ We utilise season +1 and season +2 wholesale price data from 2017 to 2020 sourced from ICIS Heren to determine the proportion of occasions where wholesale prices decreased by more than a given percentage at any point over the subsequent 14 days and the average magnitude of price decrease for all occasions above this threshold. We estimate the proportion of sales eligible for a cooling-off period under our revised proposal process using data obtained from our RFI to suppliers.

For our lower scenario, we assume that all of the most engaged microbusinesses (who are eligible for a cooling-off period) cool-off following a relatively large decrease in wholesale prices of more than 10%. For an average microbusiness consumer with a consumption of 15 MWh of electricity and 33 MWh of gas annually this represents a saving of roughly £75 on their electricity contract and £50 on their gas contract if the costs were fully passed through. We consider this to be a reasonable estimate of the level of saving required to prompt this behaviour amongst the most engaged consumers. We estimate the number of highly engaged microbusiness consumers as the 12% proportion of “Shrewd Spenders” identified in our 2018 survey.²⁹

²⁸ Ofgem, Micro and Small Business Engagement Survey 2018, <https://www.ofgem.gov.uk/publications-and-updates/micro-and-small-business-engagement-survey-2018>

²⁹ The “Shrewd Spenders” segment are the most engaged segment of micro and small businesses. These businesses have high energy expenditure and are focused on minimising costs to the business. They seek out better deals and switch regularly.

	Electricity	Gas
Threshold wholesale price fall to trigger price-related cooling-off	10%	10%
Proportion of occasions where price fell by more than threshold (A)	0.7%	4.9%
Proportion of eligible customers cooling-off when price fall is greater than threshold (B)	12%	12%
Proportion of customers eligible for a cooling-off period (C)	55%	59%
Proportion of sales where customer cools off in response to price fall (D = A x B x C)	0.04%	0.3%
Mean price decrease where price fall is above threshold (E)	14.1%	12.8%
Total risk premium (D x E)	0.01%	0.04%

For our higher scenario, we assume that the 12% proportion of most engaged consumers now cool-off following a smaller decrease in wholesale prices of more than 5%. For an average microbusiness consumer of 15 MWh of electricity and 33 MWh of gas annually this represents a saving of roughly £37 on their electricity contract and £25 on their gas contract if the costs were fully passed through.³⁰ We consider this to be a lower bound estimate of the level of saving required to prompt this behaviour amongst the most engaged consumers. In addition, we assume that a further proportion of eligible consumers also cool-off following a decrease in wholesale prices of more than 10%.³¹ We estimate this further proportion to be the 27% proportion of “Canny Considerers” identified in our 2018 survey.

³⁰ These are the average annual consumption levels for microbusinesses on negotiated contracts in 2018-19 as received from our contractual and pricing RFI which covers approximately 90% of the small business market segment. We have used the consumption values from 2018-19 to account for the effect of the Covid-19 pandemic in reducing consumption to below typical levels.

³¹ The “Canny Considerers” segment are the second most engaged segment of micro and small businesses. They have a low energy spend, but still appreciate the benefits of switching and will do so regularly.

	Electricity		Gas	
	Canny Considerers	Shrewd Spenders	Canny Considerers	Shrewd Spenders
Threshold price fall to trigger price-related cooling-off	10%	5%	10%	5%
Proportion of occasions where price fell by more than threshold (A)	0.7%	13%	4.9%	23.7%
Proportion of eligible customers cooling-off when price fall is greater than threshold (B)	27%	12%	27%	12%
Proportion of customers eligible for a cooling-off period (C)	55%	55%	59%	59%
Proportion of sales where customer cools off in response to price fall (D = A x B x C)	0.1%	0.9%	0.8%	1.7%
Mean price decrease where price fall is above threshold (E)	14.1%	7.0%	12.8%	8.2%
Risk premium (F = D x E)	0.01%	0.06%	0.10%	0.14%
Total risk premium (F_{Canny considerers} + F_{Shrewd Spenders})	0.07%		0.24%	

Using mean season +1 and season +2 wholesale prices from the 2017-2020 period this gives an estimated annual cost (across all negotiated microbusiness contracts) of £132,000 for our lower scenario and £1M in our higher scenario.

For an average microbusiness consumer of 15 MWh of electricity and 33 MWh of gas annually this represents an increase of roughly 4p and 22p on their annual electricity and gas bills respectively in our lower scenario, and an increase of £0.54 and £1.20 in our higher scenario.