

Ofgem: Default Tariff Cap Policy Consultation

Consultation response from the

Centre for Competition Policy

University of East Anglia, Norwich Research Park, Norwich NR4 7TJ

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Authors:

- Dr. David Deller
- Prof. Catherine Waddams

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

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CCP Response to Ofgem's Consultation on Default Tariff Cap

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

In general we agree with Ofgem's approach to having different caps for different payment methods. Fully socialising the different costs would risk removing the existing incentives for using lower cost payment methods, and would also likely change the behaviour of companies regarding their recruitment of the higher cost, lower profitability standard credit consumers. To some extent even partial socialisation of costs which are allocable risks such a distortion, and the observation that companies already partially socialize these costs raises the question of why they should at present be setting prices with different margins between revenue and costs for different payment methods. One obvious reason for charging lower prices to standard credit payers would be if this group were more responsive to price changes. While this concept may seem odd in the context of disengaged customers, within this group it may still be true that standard credit payers are more responsive to price changes than direct debit payers for two reasons. They may have lower incomes on average, and they get regular, if infrequent, reminders of their energy consumption when they receive and pay their bills. The fact that a higher proportion of standard credit payers falls into groups for whom Ofgem feels a particular responsibility, may make such an approach more acceptable on equity as well as efficiency grounds.

Ofgem's argument for socializing some of the costs seems to be that it does not have full confidence in the cost allocation figures. There is a particular issue over bad debt provision. How energetically bad debt is pursued is partly a distributional issue, particularly in essential services where disconnection is seen as unacceptable. The policy on how, and how much, bad debt is recovered is largely decided in principle for the system as a whole, balancing the efficiency arguments for discouraging bad debt by imposing its effects on those who incur it, against the equity issues concerned with affordability of an essential commodity. Once this balance and consequent bad debt procedures have been determined, the bad debts themselves become an overhead on the system. It is therefore not clear from an efficiency perspective that they should be allocated to the consumers on a particular payment method, rather than all consumers within the system. Moreover such allocation is likely itself to affect the level of bad debt, particularly if it raises the price for a group which is already more likely to default on their payments. Here it seems important to separate out the social and non economic arguments for a particular approach to bad debt from the accounting decisions about how to allocate it.

If relative costs differ from the allocation imposed by the price cap differential, companies are likely to reflect this in the offers they make, pursuing more energetically, through prices and marketing, consumers who provide a higher profit margin. This would reflect early behaviour in the gas market, where entrants responded to the regulator's relative caps which they argued provided less margin for prepayment, by focusing instead on credit consumers (Otero and Waddams Price, 2001).¹ While this may be less relevant in these new price caps for consumers who have a history of disengagement, it may affect which of the price-capped consumers are most likely to become active in the future, and so be a consideration in Ofgem's review of the competitiveness of the market.

¹ Otero, J and C. Waddams Price, 2001. Incumbent and entrant response to regulated competition: signaling with accounting costs and market prices, *Journal of Economics and Business*, 53, pp. 209-233.

There may also be issues for other cost differences between consumer types, in particular for those who deal with their account entirely online, and often receive a discount for doing so. If a common price cap becomes binding, these consumers will deliver a higher margin to their suppliers than those who continue to receive paper copies, and so companies are likely to direct any marketing activities towards such profitable consumers and encourage more paperless accounts. Observing behaviour in the market may provide additional information which would be relevant to Ofgem’s future market intervention.

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

In broad terms Ofgem’s comments on how to assess the conditions for removing the Default Tariff Cap (DTC) appear reasonable and we accept the assessment represents a challenge where the conclusions face inevitable uncertainty as the removal of the DTC will itself alter the nature of the market. First, we agree that as the DTC is designed to protect disengaged consumers there is need to focus specifically on whether increased engagement is likely to be seen by the *subset of consumers currently protected by the cap* (i.e. the currently disengaged). Second, while noting the DTC is likely to suppress engagement, we think information can be gained from observing market outcomes while the DTC is in place; it is a matter of taking into account the likely impact of the DTC on the outcomes observed. Third, we caution against over-optimism regarding the potential for interventions to boost the engagement of the disengaged; since Ofgem will be implementing many of these interventions there may be an understandable institutional bias to believing these interventions will be effective. Fourth, while not explicitly the purpose of the competition assessment we recommend Ofgem should transparently report any evidence the DTC is having noticeable negative impacts so that future debates about the DTC are well informed. Overall we note that producing a robustly evidenced competitive assessment favouring the DTC’s removal is likely to present challenges for any organisation and the final decision to maintain or remove the DTC is likely to be highly politicised.

1. The importance of focusing on disengaged consumers

The premise (which can be questioned) of introducing a DTC is an effectively designed DTC will: (a) offer protection to consumers currently on default tariffs (DTs), while (b) having limited negative impacts on the competitive section of the market involving engaged consumers and fixed term tariffs. We focus on (b) in section 4. Focusing on (a), we welcome the sentiments expressed in paragraph 5.13 that key to the assessment will be identifying “the right market framework is in place for competition to be effective *for currently disengaged consumers*” (emphasis added). However, this means Ofgem will need to provide evidence showing interventions are directly, and arguably disproportionately, having a beneficial impact for disengaged consumers.²

If we consider smart meters as an example, it is not simply sufficient to report that penetration of smart meters has significantly increased across the market as a whole, it will be necessary to demonstrate smart meter penetration has increased significantly specifically among disengaged consumers. This detail is non-trivial for smart meters: since smart meters are installed on an opt-in basis a reasonable starting hypothesis might be that disengaged consumers are less likely to opt for a smart meter than more engaged consumers. Given the need to look at disaggregated data when making the competition assessment, an

² Market-wide engagement/switching rates after an intervention could increase due to the already engaged engaging/switching more frequently rather than by the disengaged starting to engage.

important open question is whether data is available disaggregated by level of engagement/whether or not a consumer is protected by the DTC?

2. Interpreting market outcomes when the DTC is in place

Ofgem is correct to identify that the DTC itself will affect the outcomes observed and the behaviour of consumers in the retail energy market. However, it seems wrong to ignore the potential for relevant information to be obtained from observing market outcomes while the DTC is in place. Instead, it seems important to establish expectations of how the DTC is likely to impact the market and then interpret the outcomes observed in light of these expectations. In particular, if the DTC is expected to dampen consumer engagement, an observation that engagement has increased by a noticeable amount while the DTC is in place could be showing interventions to raise consumer engagement are having a particularly strong effect. Hence, the sentiment expressed in paragraph 5.1 regarding the inability to use market observations while the cap is in place as evidence appears too strong, rather there is a need to consider how market observations should be interpreted when the cap is in place. However, we accept the inevitable uncertainty around interpreting market observations, i.e. the DTC could alter consumers' responses to other market developments. The expectation that the DTC will dampen engagement is based on CCP research showing the most consistent predictor of switching the energy market are the monetary savings available to consumers. For example, see Deller et al (2017)³, Waddams Price and Zhu (2016)⁴ and Flores and Waddams Price (2018)⁵. The larger the savings on offer to a consumer the more likely they are to switch suppliers. The monetary incentive for consumers on DTs to switch will be the price difference between their current DT and a 'low price' fixed-term tariff. If the DTC performs as intended, it will reduce the price differential between DT and fixed-term tariffs thus reducing the monetary incentive to switch for DT consumers.

Ofgem is correct to note the DTC may also reduce the incentive to switch for currently engaged consumers who tend to be on competitive fixed term tariffs; these consumers' monetary incentive to switch to a new fixed-term tariff will be linked to the monetary saving obtained by avoiding ending up on their current supplier's DT. While both engaged and disengaged consumers⁶ are likely to see their probability of engagement reduced when the DTC is in place it seems important for Ofgem to recognise the extent of this reduction may differ across these two groups.

3. The robustness of evidence demonstrating the conditions for effective competition exist

Not only do we believe market outcomes may offer some information relevant to the competition assessment, but there are risks with focusing excessively on how the market framework has been altered to remove barriers to engagement. The evidence in Deller et al (2017) indicates there are multiple factors/barriers influencing a consumer's decision to switch and only when a consumer believes a large number of these factors have been addressed will a consumer become significantly more likely to switch. For example, while reducing the calendar time taken for a switch to complete may have some value to

³ Deller, D., M. Giulietti, G. Loomes, C. Waddams Price, A. Moniche Bermejo and J.Y. Jeon (2017), 'Switching Energy Suppliers: It's Not All About the Money', CCP Working Paper 17-5, available at: <http://competitionpolicy.ac.uk/documents/8158338/17199160/CCP+WP+17-5+complete.pdf/fdaaed88-56e5-44f9-98db-6cf161bfb0d4>.

⁴ Waddams Price, C. and M. Zhu (2016), 'Empirical Evidence of Consumer Response in Regulated Markets', *Journal of Competition Law and Economics*, 12(1), pp. 113-149.

⁵ Flores, M. and C. Waddams Price, *The Role of Attitudes and Marketing in Consumer Behaviours in the British Retail Electricity Market*, *The Energy Journal*, 39(4), pp. 153-179.

⁶ As defined by behaviour prior to the DTC's introduction.

consumers, its value is likely to be noticeably lower than interventions reducing the amount of a consumer's time required in minutes to complete a search and switch.

While paragraph 5.14 highlights a range of interventions that plausibly could reduce barriers to switching, a robust recommendation to remove the DTC not only has to find these interventions have been delivered but provide evidence they are increasing consumer engagement to a meaningful extent. By meaningful extent we mean the increase in engagement is not only statistically robust (i.e. statistically significant), but the magnitude is sufficient to address the scale of 'harm' that was perceived to justify the DTC in the first place. Again using smart meters as an example, it is not sufficient simply to note smart meters have been rolled out, it needs to be shown that disengaged consumers with smart meters are more likely to switch than those without smart meters.⁷ If Ofgem does not provide high-quality evidence on the impact of interventions⁸, declaring that the interventions have occurred so competition will be effective after the DTC has been removed risks simply being 'a leap in the dark'.

Concluding that competition will be effective because various interventions likely to increase engagement have been implemented carries two further risks. First, as Ofgem is directly responsible for the delivery of the interventions, there is likely to be an understandable, but problematic, organisational bias towards being optimistic about the effectiveness of these interventions in boosting consumer engagement. Second, the DTC has been introduced essentially due to the price discrimination observed in the market between engaged and disengaged consumers being judged to be excessive. If interventions increase the proportion of consumers that switch this reveals information to suppliers that the non-switchers remaining after the intervention are on average even 'stickier' than the average of non-switchers prior to the intervention. This could create an incentive for suppliers to increase their DT prices post-intervention, holding all else equal. This means that post-intervention, and in the absence of the DTC, while the proportion of switchers may have increased, the price differential between switchers and non-switchers may also increase. In other words, those induced to switch by the intervention should see an improvement in their welfare, but those not induced to switch risk experiencing price increases. How Ofgem should view the potential for this trade-off in its competitive assessment is unclear.

4. The need to report if the DTC has negative impacts

As noted in section 1, the premise behind the DTC is those on DTs can be protected without having a noticeable detrimental impact on the operation of the fixed-term tariff segment where competition is perceived to have been effective prior to the DTC. That competition in the fixed-term tariff segment will not be meaningfully undermined by the DTC is a hypothesis to be explored rather than a fact. We suggest Ofgem reports as part of its competitive assessment any evidence indicating the DTC has weakened competition/significantly worsened outcomes in the fixed-term tariff segment. This evidence may provide an important factual basis for the political debates that seem inevitable around the decision to remove/maintain the cap. Raising awareness of negative impacts is also important since CCP's earlier consultation response to the draft DTC bill⁹

⁷ Furthermore, observed switching rates offer much stronger evidence than surveys simply identifying that households with a smart meter report a greater intention to switch.

⁸ We note that assessing the impact of interventions occurring when the DTC is in place will need to use the approach expressed in section 2.

⁹ Deller, D., E. Errington, A. Fletcher, M. Hviid, D. Reader and C. Waddams (2017), CCP consultation response to 'Business, Energy and Industrial Strategy Committee: Pre-legislative scrutiny of the draft Domestic Gas and Electricity (Tariff Cap) Bill Inquiry', available at:

noted a literal reading of the draft legislation seemed to imply that if the DTC itself was found to be impeding competition it could not be removed as the conditions for effective competition would not currently be in place.¹⁰

<http://competitionpolicy.ac.uk/documents/8158338/16525214/6+CCP+response+to+BEIS+Committee+Energy+Price+Cap+Inquiry.pdf/236d419d-d157-2e0e-2eea-0923d75dd035>.

¹⁰ CCP recommended changes to wording of the bill to remove this issue (see p. 10-11 of the response). In theory the wording issue could also be overcome by setting a DTC involving an arbitrarily high price, i.e. such a high price that the DTC is never binding on firms' pricing decisions. While this latter approach would work in simple rational models of firm and consumer behaviour, in practice there is the risk of unintended consequences if market actors follow a more 'behavioural' approach and the DTC continues to have some influence as a reference price even when set at a non-binding level.