Do Consumers Switch to the Best Supplier?

BACKGROUND

- Policy makers are placing increasing emphasis on the positive role that consumers should play in generating market competition by the choices they make. Consequently there is increased interest in the barriers that affect consumers' ability to switch supplier.
- There are well-recognised costs which may prevent consumers from switching – switching, search and cognitive decision-making costs. Most literature however has concentrated on switching costs.
- This paper examines the importance of search and cognitive decision-making costs. It analyses the accuracy of consumers' switching behaviour insofar as they choose (or do not) to switch to a lower cost supplier. Findings show that significant numbers of consumers are switching to higher cost suppliers, suggesting that complexities in the market create consumer detriment and prevent the market from working well.
- Liberalisation of the residential electricity market was completed in 1999. Few new suppliers have entered the industry and competition has consisted of regional incumbents entering other regional markets where they had not been incumbent, and British Gas.
- Despite the opportunity to switch to a cheaper supplier around 50% of electricity consumers have stayed with their incumbent supplier.

METHODOLOGY

- The research analysed two consumer surveys. The first, conducted on behalf of the Electricity Association, was undertaken between March and August 2000 and was intentionally biased towards low income consumers. Of 3147 consumers surveyed 523 had switched electricity supplier and of these, 373 responses were used in the research. The second set of data was collected by MORI for CCP in June 2005. Of 2027 consumers surveyed, 370 had switched electricity supplier in the previous three years and 245 of the responses were used in the research. Two data sets were constructed from the data to analyse whether consumers who chose to switch (and whose principal reason for switching was lower prices) had moved to a cheaper supplier. By focusing only on consumers who had switched to save money it was possible to eliminate unobserved benefits such as quality of service or preference for green tariffs.
- The data were used to measure the accuracy of consumers' switching decisions by measuring both the maximum possible gains in surplus that each could have achieved by switching to the best supplier for them and the gains that each made through their actual choice of new supplier.

KEY FINDINGS

- Only 8-19% of consumers switched to firms offering the highest savings and in aggregate switching consumers only appropriated between 28% and 51% of the maximum gains available through their choice of new supplier. Such choices are only marginally better than the gains that consumers would have received from switching to a randomly selected supplier (this would have offered a 7%-14% chance of choosing the cheapest supplier and appropriated 25-30% of the savings available). These results are consistent with an explanation of high search costs.
- However, not all findings could be explained by issues related to search costs. 20%-32% of switching consumers appear to have lost money through their choice of supplier.
- These consumers lost an average of £14-£35 per year. This result could not be explained by unmeasured preferences since the analysis had been restricted to those consumers who had said they switched simply to save money. Neither could it be explained by consumers incorrectly estimating their consumption because results were derived from consumers' own beliefs and remained robust across different consumption levels. Nor could it be explained by pressurised or misleading selling since consumers' choices were insignificantly related to the self-reported influence of a sales agent or an increase in

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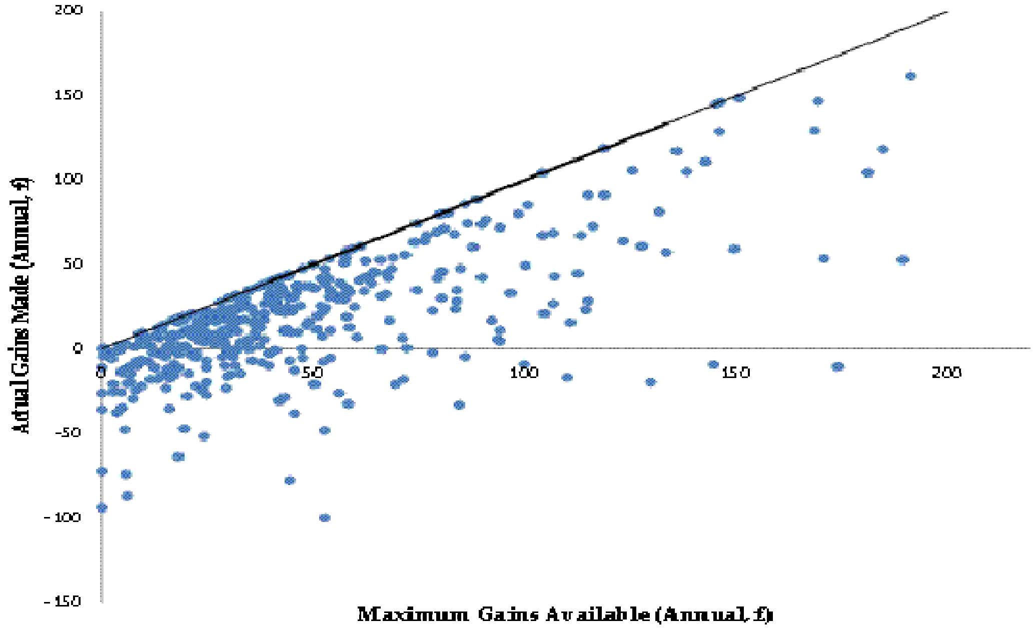
selling activity by suppliers. The findings were most consistent with an explanation that the failure to maximise savings was simply that consumers made poor decisions.

Figure 1: the actual gains made from switching relative to the maximum gains available.



This figure shows that many consumers have not appropriated the maximum gains available which is shown by the points located off the 45° line.

It also shows that a significant number of consumers have lost surplus by switching to a more expensive supplier, shown by the number of points below the x-axis.

POLICY ISSUES

- After significant increases over the past three years, prices are now decreasing. Regulatory and consumer bodies are exhorting consumers to switch supplier. However there is concern that consumers will not be able to take advantage of the savings that are available to them. More work is needed to assess whether the complexity of tariff structures in the market are acting as a barrier to effective consumer participation.
- The findings suggest that there needs to be an improvement in consumers' access to and use of pricing information. It may be necessary to re-examine the nature of the pricing information which is available to consumers to ensure that it is presented as clearly as possible. Policy makers may also want to look at whether the extent of choice in the market is in fact acting as a barrier and in reality reaffirming the market power of market participants.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

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The full working paper (CCP Working Paper 07-6) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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