



Ofgem: Protecting consumers in collective switching schemes

Consultation response from the ESRC Centre for Competition Policy

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The response to this consultation has been drafted by the academic members of the Centre listed above. The document has been edited by Professor Morten Hviid following discussions held in the Centre and it has the broad agreement of the group of contributors.

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Background and CCP research on collective switching

The consultation document does not clearly explain Ofgem's analysis of the market, nor does it establish a clear theory of harm. Before answering some of the questions in the consultation document we offer our assessment, based on ongoing research at the ESRC Centre for Competition Policy.

There is a presumption that switching is both insufficient and undertaken by the "wrong" people. The main driver behind this view is that there remains a substantial fraction of consumers who have never switched energy supplier, who are hence with their original incumbent and are paying more than necessary. Further, there is a concern that a disproportionate number of these non-switchers belong to a vulnerable category whose needs Ofgem has a statutory duty to take into account. Current intense political and media lobbying, creates a pressure to "do something" and to be risk averse about letting experiments play out. Before acting, it is important to assess the presumptions behind this desire to intervene. One increasingly important factor in assessing the equity of the switching process is who is active in the market and is likely to get better deals, and who is inactive and may be left on more expensive tariffs.

CCP work based on a series of surveys since the market opened shows that the link between switching activity and measures of potential vulnerability is complex. For example, although fewer vulnerable people had switched away from their incumbents electricity supplier in 2005 than the average for the rest of the population, more had switched than had not done so. So a policy which subsidised non switchers at the expense of switchers would disadvantage more of those in potentially vulnerable groups than it would help (Hviid and Waddams Price, 2012)¹. Evidence suggests that those of pensionable age are no less likely to switch than those who are younger, indeed the group which switches least is the middle aged, around 45 to 55 (Giulietti et al., 2005; Flores and Waddams Price, 2013; Waddams Price et al., 2013)², who are less active in all markets than their younger and older counterparts. However it seems that while the middle aged are less likely to switch, they make fewer errors when they do so (Wilson and Waddams Price, 2010)³.

Those with lower income are more likely to switch supplier, controlling for other factors, but are no more likely to search than other households, so their switching may be less accurate (Waddams

¹ Hviid, Morten, and Catherine Waddams Price, 2012. "Non - Discrimination Clauses in the Retail Energy Sector*." *The Economic Journal* 122, no. 562: F236-F252.

² Flores, Miguel and Catherine Waddams Price, 2013. "Consumer behaviour in the British retail electricity market". Centre for Competition Policy, University of East Anglia Working Paper 13-10

Giulietti, Monica, Catherine Waddams Price, and Michael Waterson, 2005. "Consumer choice and competition policy: a study of uk energy markets." *The Economic Journal* 115, no. 506: 949-968.

Waddams Price, Catherine, Catherine Webster and Minyan Zhu, 2013. "Searching and Switching: Empirical estimates of consumer behaviour in regulated markets". Centre for Competition Policy, University of East Anglia CCP Working Paper 13-11

³ Wilson, Chris M., and Catherine Waddams Price, 2010. "Do consumers switch to the best supplier?." *Oxford Economic Papers* 62.4: 647-668.

Price et al., 2013). However evidence from a low income group in the early days of switching shows little evidence that those with less income make greater errors than others (Wilson and Waddams Price, 2010).

Preliminary results from a collective switching auction show over-representation by the middle aged group who seem to be less active in the regular switching process, suggesting that they may galvanise a usually inactive (and presumably “time poor” group) into action. But these are not generally viewed as a vulnerable group. Within the non-representative group who participated in collective switching we find that income has little effect on whether or not an individual accepts the auction offer (once other factors such as size of gain are controlled for). Unsurprisingly those in rented accommodation are less likely to switch, either in an auction or in more regular market interactions.

When a significant number of consumers leave a substantial (in excess of £100) amount of money on the table by choosing to be inactive in a market, we would expect institutions to emerge to arbitrage away some of these differences. These institutions include: Price Comparison (switching) Sites, Brokers (more commonly used by business customers) and Collective Switching Schemes which can all be seen as private responses to a market which is not working well. It is worth being clear that if the energy market worked well none of the three private responses would be financially viable [or indeed necessary].

What might motivate consumers? Existing CCP research cited above shows that the reasons for the market not working well are many and varied. The market may not work well for a number of reasons, particularly asymmetric information, the cost of collecting information, the cost of processing information and strategic behaviour by firms. Importantly, consumers may have their own preferences over the three private institutions which support searching and switching. Research at CCP on a collective switching scheme indicates that when offered more than one choice, the probability of switching decreased. This is an important insight because it suggests that those who signed up for such a scheme did not want choice – if they had done so, they could simply have gone on a price comparison site. There are indeed good reasons to think that the institutions are substitutes for each other (and to some extent for direct participation in the market) and that choice by consumers reflect their preferences. Arguably the three private responses aim to [or are most effective to] resolve different shortcomings in the market

- *Price comparison web sites deal with incomplete information and in particular the cost of collating information – but the consumer has to process the information and make the final choice without support.*
- *Brokers deal with the cost of collating and processing information with the choice delegated other than the final choice between the status quo and the deal identified by the broker.*
- *Collective switching deals have the potential to create countervailing buyer power and mitigate competition problems by directly playing one firm off directly against the others. The consumer has a final choice between a single offer (usually) and the status quo.*

Thus price comparison sites are about collecting information, brokers are about processing information and collective switching schemes are about buyer power which can help to counteract potential seller power. They also provide consumers with a different choice problem. Comparison sites are for those who want to scan the whole horizon and are prepared to spend time processing the information. Brokers are for those who do want to scan the horizon but who would like this information “pre-processed”. Collective switching schemes are for those who want a better deal without the hassle of finding the best deal. Among the three methods, clearly the first has the highest implied cost for the consumer and the last the lowest. It would have been helpful if Ofgem had been more explicit about the differences between a switching web site, a broker and a collective

switching scheme and when a consumer would choose to use one or more of these. For example, it is not clear that whole market deals from collective switching schemes make sense – they are either for the comparison web sites or for other types of intermediaries such as brokers.

What might motivate bidders in a procurement auction organised by a collective switching scheme? Clearly the collective switching scheme needs to be able to offer potential bidders something valuable they cannot easily get in any other way. The value has to be significant to more than one potential bidder. For a procurement auction, there have to be at least two bidders who are keen on the target for the bid. What then are the possible benefits? Benefit to the bidder arises from at least two fronts:

- *Obtain a block of consumers to realise the value in pushing the consumer base to a new level where there may be returns to scale, or in spreading the cost of expanding supply beyond a certain level across more consumers. Given the relatively modest current size of the potential block of consumers, it is evident that most schemes will be more attractive to small entrants than established suppliers.*
- *Obtain consumers with a known set of characteristics which can be exploited in the future.*

One important issue is whether opt-out rather than opt-in schemes offer better value for the bidder. The difficulty in assessing this arises because this can be on two levels: into the scheme itself and into the generated offer. Opt-out schemes tend to generate larger blocks of consumers. Thus if a particular group was automatically enrolled in the scheme unless they specifically opted out and then automatically switched to the tariff arising from the procurement auction unless they further opted out, this would provide the winning bidder with the largest possible block of new consumers. However, opt-in would at both levels create a more coherent group which might have greater long term value to the gaining provider.

Further important points which Ofgem should consider are:

- *The switching scheme must be able to cover its costs. The greater the regulatory burden of the process, the higher these costs will be.*
- *In designing a procurement auction, transparency may not be desirable. This depends entirely on what the transparency relates to – unfortunately this is not clear from section 2 in the document. The whole point of collective switching is that by representing a lot of demand, the scheme generates buyer power which can be leveraged to the benefit of consumers. This is not about fairness [market mechanisms are not well suited to equity objectives] this is about getting a better deal than the status quo.*

Collective switching schemes are new and the business model is not clear and nor is there necessarily an obvious or optimal one – comments such as 2.15 only demonstrate that some of the auction designers have some work to do – so schemes will need time to experiment. DECC's investment in these can be seen as enabling such experimentation.⁴ While it may be appropriate to be ready to intervene once there is evidence of harm, Ofgem should be careful not to curtail valuable experimentation through what may be premature intervention.

⁴ Indeed this could justify the rather unimpressive returns from the £5 million investment.

NOTE added 8 August 2014: In addressing the consultation questions below we assumed that Ofgem was proposing additional constraints on collective switching agreements, while we have since understood that the issue is whether to devise specific regulations which may be less onerous than those which apply to switching sites, so that Ofgem's aims are to reduce rather than increase the controls on collective switching. We are in sympathy with such reductions, and our answers to the questions should be read in relation to proposals to introduce additional controls.

The consultation document asks the following questions:

1. *Do you agree that the growth of collective switching, and the potential opportunities and detriment resulting from this, merit short-term action to ensure consumer protection while Ofgem works on a longer-term approach?*

Given the amount of regulation already in place, see answer to question 6 below, there is a strong argument for Ofgem to take a back seat and let these new schemes develop and mature so we can seriously assess whether they have much of a future. Before intervening, Ofgem should at least demonstrate a more complete and comprehensive understanding of the purpose and mechanism of a collective switching scheme. Ofgem may well want to monitor that the organisations satisfy the standard requirements for marketing and generally for trading, but at this stage, surely this is sufficient.

The document appears very paternalistic: [paragraph 1.6 but similar concern raised in 3.4] "This organiser is often a trusted intermediary familiar to consumers (eg a local authority, housing association or charity), but it may not be an expert in energy matters." Is this concern warranted? Those organisations would face the danger of losing important reputation for their core activities and hence they are likely to participate with their eyes open and make sure that they know enough about the market.

2. *Do you agree that some form of accreditation is the best approach? If not, what other approach would be best?*

No – no evidence is offered that such an intervention is warranted.

According to the consultation document, 31 schemes alone were supported by funding from DECC, suggesting that there is currently no shortage of such initiatives [even though arguably the majority offered little in the way of value for money]. No evidence is offered in the document that the number of people engaging with these organisations is inadequate, nor that consumers are deterred by lack of trust in the organisations.

Is it sensible at this stage to make these schemes costly to administer by increasing the level of associated bureaucracy? How are the collective switching organisations going to cover the costs of accreditation?

3. *If an accreditation approach is used, do you agree that building on the Confidence Code is the most proportionate and effective solution?*

See answer to 2.

4. *Do you agree that the exemption for collective switch tariffs under Ofgem's rules on the number of tariffs offered by each supplier should be available only where the collective switch is accredited under the Confidence Code?*

No – and paragraph 1.15 is unclear. Indeed the offers through the collective switching schemes may have the benefit of avoiding some of the disadvantages of the RMR.

5. *We will consider the Personal Projection as part of our Confidence Code review. Are there any key differences between collective switching and price comparison which require separate consideration for the Personal Projection? If so, please explain why.*

6. *Can an expanded Confidence Code influence marketing claims?*

There is already in place a quite comprehensive - though fragmented as it is enforced by different bodies - regulatory framework governing marketing and advertising in the UK. The Consumer Protection from Unfair Trading Regulations 2008 regulating advertising to consumers, the Business Protection from Misleading Marketing Regulations 2008 regulating advertising to businesses, both enforced by the CMA or by a local Trading Standards Office and the Conduct for Authorised Persons Rules 2003 governing telemarketing; to name but a few. Part of the existing framework implements the EU Directives into UK Law - as is the case with the Privacy and Electronic Communications (EC Directive) Regulations 2003 (PERC), which govern direct marketing practices and are enforced by the Information Consumer Office and OFCOM, whereas supplementary guidance has been provided over time by regulatory authorities. There also exist two Advertising Codes of Practice describing how businesses should advertise, namely the Non-Broadcast Media and the Broadcast media enforced by the Advertising Standards Authority. Finally, significant penalties may be put in place for breach of the regulations such as fines, prosecution or imprisonment.

Given these existing provisions, adding an additional layer of regulation in an 'expanded' Confidence Code is an unnecessary action. A less burdensome measure would be to remind the collective switching schemes of the law and practice governing marketing and advertising in the UK.

7. *Should an expanded Confidence Code cover telephone and face-to-face interactions specifically for collective switching?*

For the reasons outlined above, we do not think that face-to-face and telephone marketing would be a dominant feature of successful collective switching schemes, so we suggest action by Ofgem at this stage would be inappropriate.

8. *What further guidance/code requirements are required in the Code to protect consumers and help to facilitate collective switching schemes which involve face-to-face engagement and telephone interactions?*

9. *What views do you have about what could support improved PPM engagement?*

This seems an obvious target for collective switching since the scheme organiser could simply purchase cards from a supplier and then sell them on. Such action would offer many advantages and Ofgem might wish to consider which philanthropic organisations would want to explore such a scheme.

10. *What areas of data collection or handling, specific to collective switching, should be covered by the code? Are there gaps that need to be covered which are not already covered by the existing data protection legislation?*

11. *Do you agree with our proposal to expand the Confidence Code to service providers but not scheme organisers?*

Yes.

12. *To what extent will the additional criteria affect: (a) suppliers: will the amendment increase or decrease involvement in collective switching, and why? (b) consumers: will the amendment increase or decrease involvement in collective switching, and why?*
13. *Are there areas in an expanded Confidence Code: that we have not indicated that you think should be additionally covered for collective switching, or that we have indicated for inclusion in the Code that you think should not be covered for collective switching?*

No – but see comments above.

14. *What areas of data collection or handling, specific to collective switching, should be covered by the Code? Are there gaps that need to be covered which are not already covered by existing data protection legislation?*
15. *What further guidance/code requirements are required in the code to protect consumers and help to facilitate collective switching schemes which involve face-to-face engagement and telephone interactions?*

See response to 6 above. There is already considerable protection, and a clearer theory (or evidence) of harm is needed to justify intervention.
