Department of Energy and Climate Change: Ensuring a better deal for energy consumers

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Consultation response from the ESRC Centre for Competition Policy

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Response to DECC's consultation on ensuring a better deal for energy consumers
From Catherine Waddams

This response to DECC's proposals supplements that to the concurrent Ofgem consultation, to which a CCP response was sent in December 2012, with appropriate references . This response is included as an annexe to this paper, which addresses the specific issues and questions raised in the DECC consultation document in the main body. Answers and comments to specific questions are marked below with the relevant question number.

Para 1.1 refers to the cheapest tariff which meets individual preferences. In a market economy these preferences are generally left to the individual to act on, since it is so difficult for a third party to identify them. In over-ruling this market based 'revealed preference' approach, it is important that any policy makers are sure they know what individual preferences are, so they do not impose a solution which turns out to be worse (in terms of their own preferences) for the consumers concerned.

While it is true that the majority of consumers do not actively seek out the best deal on the market, it is unclear whether this phenomenon is more marked in energy than in other markets, where greater product heterogeneity makes it more difficult to identify whether a better deal is being 'left on the table'. The estimates of potential savings are somewhat misleading, since it ignores any response from suppliers if consumers were to try and take these up in large numbers, either from self motivation or by the various schemes for putting customers on better deals.

Questions 1-3: Constraining tariff numbers is inevitably arbitrary, and while it may remove barriers to switching, it will not necessarily stimulate switching activity. For this reason it is difficult to know whether the chilling effect on innovation will be balanced by equivalent benefits from greater switching. If there were extensive switching, this might stimulate competition, but the restrictions themselves will have an anti-competitive effect, and may well make co-ordination between providers easier.

Analysis of energy switching suggest that the main incentive to switch supplier is gains available, but that many other factors also affect, and inhibit, switching[1]. Therefore …

[1] See for example Ofgem's own econometric evidence cited at Appendix 2 (p.145) of http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf; Effective empowerment: empirical estimates of consumer switching behaviour by Catherine Waddams Price and Catherine Webster, CCP mimeo 2012; and Non-discrimination clauses in the retail energy sector by Morten Hviid and Catherine Waddams Price, The Economic Journal, 122 (August), F236-F252, 2012

…(**Q4**) Clearer information alone is likely to have little effect on consumer engagement. While tariff comparison tools may help (**Q6**), the most obvious comparison is that currently provided by price comparison websites; focusing on enabling these to be more accessible and reliable may be the best way forward (**Q7**).

Q8. Vulnerable consumers tend to be vulnerable across markets, and it would benefit such households to see joint efforts across government departments and agencies to provide assistance to the consumers concerned rather than a variety of methods which need to be separately accessed and might be effective in only one market. Moreover research consistently shows that (in)active consumers tend to be (in)active across markets[2]. Where such consumers are constrained by time or mental or physical capacity such support could improve their welfare and provide effective consumer pressure across several markets, appropriately focusing on the needs of the household. Co-ordination might also help make the best use of limited resources (**Q9**). Helping such consumers to get the best deal is likely to be better than providing a 'special' tariff, which too easily becomes a poor deal relative to others, the more so if the rest of the market is working well.

Q10. Providing data in new formats is unlikely to stimulate extensive additional engagement, for the reasons outlined above. In particular it is unlikely to help vulnerable consumers on its own. But other agents might be able to use such information on behalf of such consumers, and much of the potential power of midata lies in being able to give it to others, for example other energy businesses who could then provide a reliable estimate of energy bills if the consumer were to switch to them.

Q12 Collective purchasing and switching can increase engagement, and the current analysis of The Big Switch data by CCP should provide more information on the potential of such schemes and how best to design them.

Q14. It would seem premature to take a more formal regulatory approach to TPIs until the nature of any potential problems is better understood, so that any regulation can provide for appropriate remedies.

[2] Consumer choice and competition policy: A study of uk energy markets by Monica Giulietti, Catherine Waddams Price, and Michael Waterson in The Economic Journal, 115 (October), 949–968; and Effective empowerment: empirical estimates of consumer switching behaviour by Catherine Waddams Price and Catherine Webster, CCP mimeo 2012

Annexe:

Response to Ofgem's Retail Market Review - Updated domestic proposals

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Consultation response from the ESRC Centre for Competition Policy

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21st December 2012

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Our response is in three sections: A summary of analysis of recent behaviour in the UK domestic energy market; an explanation of the basis of these results; and responses to some of the specific questions posed by Ofgem. This is based on the joint work of the authors, who jointly submit the report, with individual contributions in response to question 10.

1. Summary of our findings

We find that there are several barriers to activity in the market, and that even when search has been achieved via a trusted and authoritative website a large number of people do not proceed to switch. The collective switching exercise in particular shows that for those who were told, on good authority, that they could save over £50 per year, less than half proceeded to make the switch. Of course there may be reasons why particular consumers did not switch, but this provides an upper bound on 'engagement' levels from a group of consumers who had already taken the initiative to

contact the auction organisers, had provided substantial details about their energy demand and suppliers, and who had only to fill in a small amount of further information. This figure makes us doubtful that making price comparisons easier will have a substantial effect on switching rates, or other engagement in the market, though each may help to a small extent. Ofgem's own actions since the Energy Supply Probe in increasing price transparency themselves seem to have had little effect in maintaining the levels of switching, which have continued to fall.

In contrast, higher gains are an important driver of switching. Amongst our active consumers an increase in savings of 1% of the energy bill (£12 a year) raises the probability of switching by three percentage points for a typical consumer. This compares with a rise in the probability of switching of around five percentage points in searching and switching for a similar increase in expected gains amongst an active subgroup of our representative survey sample. These estimates are consistent with those from a survey in 2005[3], where an equivalent reduction in expected gain resulted in a three percentage drop in switching probability. Similar results were found for gas switching in the early days of market opening for expectations of sustained savings[4], showing remarkable consistency as the residential markets have developed.

We also have evidence that consumers are more likely to switch if they are confident in the savings they would make. Amongst the collective switchers, once other factors had been controlled for, consumers were four percentage points more likely to switch if they had a bill in front of them than if they relied on their own estimate/recollection of the bill; while those who relied on the estimates of a third party (based on house type and household size) were ten percentage points less likely to switch than if providing their own estimates from memory. This may result partly from different consumer types (those who have the bill in front of them may be more organised and behave differently, including in their switching actions), but nevertheless suggests that confidence in the reliability of the savings is important.

However our other findings suggest that providing consumers with more information may not stimulate greater switching. Those facing a choice of two ways to save money seemed to be five percentage points less likely to choose either than those who were given only one recommendation, which appears consistent with findings from psychology that more choice may inhibit decision-making. This has important implications for Ofgem's interventions in presenting consumers with several ways in which they can save money by engaging with the market.

2. Research basis of our response

[3] Effective empowerment: Empirical estimates of consumer switching behaviour by Catherine Waddams Price and Webster, mimeo, 2012

[4] Consumer choice and competition policy: a study of UK energy markets, by Monica Giulietti, Catherine Waddams Price and Mike Waterson, 2005, The Economic Journal, 115 (October), 949–968

CCP's response to the consultation is based on preliminary results from analysis of a large collective switching exercise, The Big Switch, conducted by *Which?* in Spring 2012, and evidence from a survey of over 2000 representative consumers in January 2011, as well as earlier research. These sources enable us to observe both the (in)actions of consumers and choices in deciding to change supplier; and their reported actions (as recalled by them over the past three years) from the survey data.

For The Big Switch our results are based on initial analysis of 109,000 consumers who opted for online direct debit payment (the largest auction category) in Spring 2012. These are of course not representative of the population as a whole. They are those most accessible by a campaigning and activist consumer association and a political campaigning group. Amongst those who were originally reached by the publicity and indicated their initial interest, this subgroup provided the reasonably detailed information necessary to enter them into the auction and notify them of potential gains from switching either to the auction winner or to the best deal on the market or to both. So this group of consumers is among the most active in the market, and their response can be seen as an 'upper bound' to potential activity across a more representative group.

The survey data are based on a representative sample of individuals, but some of our analysis is restricted to consumers who can give us estimates of how long it would take to search and switch and their expected gains from changing suppliers. Again those who were able to provide such estimates were more active than the group as a whole (no doubt partly because interaction with the market enabled them to provide such estimates). Among some of these consumers we found that experience of switching other products was important, confirming the findings of earlier surveys. This earlier work also emphasised the importance of expected savings and how long they would last in stimulating switching behaviour.

We conclude that while making comparisons easier in the markets is likely to remove some barriers to switching, more important factors are the inattention of consumers, a factor emphasised by the low switching rate even among those who had already taken some initiative and invested a considerable amount of time in providing the necessary information. This conclusion is supported by experimental work which shows the importance of both complexity and inattention in a laboratory setting[5] which mimics the energy market.

The results cited above suggest that the proposals may be ineffective because consumers hesitate to switch, even those who have invested effort in finding out what savings are available, have these clearly demonstrated from a trusted source, and for whom the next steps are relatively easy. But we are concerned that Ofgem's proposals may also be counterproductive if they facilitate co-ordination between companies which will inhibit competitive pressure. There are already widespread concerns

[5]Complexity and Smart Nudges with Inattentive Consumers by Stefania Sitzia, Jiwei Zheng and Daniel John Zizzo, CCP working paper 12-13

about co-ordinated effects in the energy markets. The forced simplification of tariffs, and any requirement for companies to give their consumers information about their competitors' charges, will exacerbate these concerns. While we are pleased to see the lapse of the non discrimination clauses, which unfortunately seem to have had the anti competitive effects predicted in our response to consultations about their introduction[6], there is a real danger that many of the present proposals to simplify tariffs will have similar adverse effects. In particular, they could lead to reduced rivalry between the suppliers, which would mean that there are smaller gains available from switching; our research shows that (unsurprisingly) this alone will reduce switching rates, similar to experience with the non discrimination clauses. And if the major suppliers are not competing vigorously with each other so there are few competitive offers available, consumer switching will not drive down prices

3. ***In response to some of Ofgem's specific questions:***

CHAPTER: Two

Question 1: Do you agree with our characterisation of the problems in the retail energy market?
Question 2: Do you agree with the findings of our evidence base?

We believe that there are problems in relying on the reasons which consumers give for inactivity, and while these reasons may identify some of the barriers, others are likely to remain. Our own surveys ask consumers about their actions and expectations, so suffer some similar disadvantage of recall and justification. Preliminary evidence from the collective switching data, which have the benefit of recording consumer actions, suggest that there are barriers to switching, even when all the necessary information has been presented by a trusted source and consumers have already invested a considerable amount of time in providing information.

CHAPTER: Six

Question 1: Do you agree with our view that the cheapest tariff message should include both supplier's cheapest tariff for their payment method, consumption and meter type, and the cheapest overall tariff from their supplier irrespective of their current circumstances, personalised by consumption?

We note that consumers faced with more information and choice are significantly less likely to be active. Ofgem's proposals may discourage activity by providing too much information.

[6] Non-discrimination clauses in the retail energy sector by Morten Hviid and Catherine Waddams Price, 2012, The Economic Journal, 122 (August), F236–F252

CHAPTER: Seven

Question 1: Do you agree with our proposal to introduce a price comparison tool?

A price comparison tool is likely to be a useful metric for those consumers who currently find price comparison sites difficult or inaccessible, and we would see value in simplicity, even at the expense of some accuracy. If more consumers are active, this should reduce the price for all by exerting competitive pressure on suppliers. An alternative is a bespoke comparison tool provided by a trusted and reliable source, such as was provided by the auctioneer in the collective switch, or is available through price comparison websites.

CHAPTER: Eight

Question 1: Do you agree that the revised Standards of Conduct (SOC) will help achieve our objectives?

Given the importance of confidence in the estimates, we believe that Ofgem is right to try to increase trust in the way that consumers regard the energy markets, where such trust is justified. In particular enforcing the anti fraud laws which already exist is important for building trust in the markets and the companies which operate in them, and may provide a more effective route than introducing additional requirements.

CHAPTER: Ten

Question 1: Do you agree that we should trial a Market Cheapest Deal initiative?
Question 2: Do you consider there are other approaches we should consider to address the particular issues with engaging sticky and/or vulnerable consumers? If so, what are they?
Question 3: Would you be willing to work with us in conducting the trial?

Question 1: The evidence cited earlier suggests that a Market Cheapest Deal initiative would be unlikely to succeed. Even if a household's annual statement showed:

a) How much the household had paid for the year's consumption
b) How much they ***would*** pay for the same consumption if they were on their own supplier's best deal for that level of consumption
c) How much they would pay for the same consumption if on the best deal offered by ***any*** supplier for that level of consumption (if different from (b) above)

d) A Freephone number and web link (and/or other facility) to enable the consumer to switch

the results from the collective switch auction suggest that there would still be many consumers who would not switch even if they could save £50 or more.

Furthermore, Catherine Waddams comments:

For suppliers to be required to alert consumers to their competitors' cheaper deals constitutes a major intervention in a supposedly competitive market. It would probably have little effect on the very sticky customers, and would involve a degree of sharing of pricing information by competitors which in other circumstances would provide prima facie evidence of collusion. It is difficult to see how the competitive market would continue to function under such circumstances. It would be far preferable for such information to be provided by a trusted third party, through a comparison web site of some kind.

And in response to question 2, Graham Loomes suggests:

Question 2: A more radical approach may be required. The practicalities would need to be explored and considered carefully, but the fundamental idea would be to have a facility which allows consumers to buy the energy they need at any time from any supplier at whatever 'spot' price they choose at that time, with each supplier's spot price posted on a central website and displayed/available at other outlets (e.g. supermarkets, Post Offices, other stores). For example, if a household receives a statement from their electricity supplier (company A) saying that they have consumed X kwh during the previous 3 months for which company A's charge is £150, they may if they wish go to the central website (or call in at the relevant counter when doing their supermarket shopping) and buy those X kwh for whatever is the lowest price on offer – say £130 from company B. Thus company B receives £130 from the consumer, while company A receives the X kwh from Company B, reducing by X the amount of electricity A needs to buy on the wholesale market. While the precise operational details would need to be thought through carefully, such a system would in principle encourage smaller companies / new entrants to offer prices which could make the market more competitive.

Question 3: The Centre for Competition Policy, including both the respondents, would certainly be willing to work with Ofgem and other interested parties to examine the practicalities of this and other innovations.