

Competition and Markets Authority: Energy Market Investigation - Supplemental Notice of Possible Remedies

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 retains responsibility for its content.

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Response to CMA Energy Market Investigation – Supplemental Notice of Possible Remedies

We welcome the opportunity to comment on an additional remedy that could act as an alternative to a regulated safeguard tariff. Before answering the consultation's specific questions we provide some background thoughts on the merits of the proposal for Fixed Term Default Tariffs (FTDT). These general comments are built around two issues: (i) giving the correct weight to switching costs when evaluating the proposed remedy, and (ii) the extent to which the proposed is genuinely transformative compared to 'evergreen' tariffs.

Switching and Consumer Welfare

It is critical that the CMA's decisions about which remedies to pursue are driven by the objective of maximising consumer welfare/total welfare. A high switching rate may indicate that a competitive market is functioning well and that it is delivering a good outcome in terms of welfare. However, switching in the energy market, like any other market, should be considered as an intermediate indicator of market functioning, rather than an objective in and of itself. Switching only leads to increased welfare for the individual consumer if the gain in welfare from switching supplier (from lower prices or increased quality) exceeds the cost of switching; if this is not the case consumer welfare is reduced by increased switching. It is potentially instructive that the value of focusing on end objectives rather than intermediate indicators has been shown in the monetary policy sphere: direct targeting of the money supply was rapidly abandoned, but inflation targeting became the consensus approach.

While we do not support a safeguard tariff on the grounds of its potential negative impact on wider competition, for a correct evaluation of FTDTs relative to a safeguard tariff the CMA has to give the correct weight to the costs of switching involved in the FTDT proposal. One way to interpret the low rate of switching among consumers who are currently on Standard Variable Tariffs (SVTs) is that they have particularly high switching costs that make it rational for them not to switch (even if absent the switching cost, they would prefer to be on a different tariff/with a different supplier). There is a danger in pathologising non-switching as a 'bad' behaviour; it may be fully rational even when a consumer claims dissatisfactions with their current supplier. Evidence for high switching costs in the energy market has previously been identified by both experience of sticky customers in the market and by various research evidence, including that from CCP research. In particular, Waddams Price and Zhu (forthcoming)¹ show the considerable variation in propensity to search and switch across markets (including energy), demographic groups and individuals, even after controlling for expected gains and anticipated time involved, and these differences are confirmed in Flores and Waddams Price (2013)². Even among those who had joined a collective switching auction³ to save money and who were offered an annual saving exceeding £100, around 40% of consumers did not accept the offer they received. That consumers may not appreciate being required to make switching decision is illustrated by the

¹ Catherine Waddams Price and Minyan Zhu (forthcoming 2016), Non-discrimination clauses: their effect on GB Retail Energy Prices 2005-2013, *The Energy Journal*

² Miguel Flores and Catherine Waddams Price (2013), *Consumer Behaviour in the British Retail Electricity Market*, CCP Working Paper 13-10

³ David Deller, Monica Giulietti, Joo Young Jeon, Graham Loomes, Ana Moniche and Catherine Waddams (2014), *Who Switched at 'The Big Switch' and Why?*, Report for Which?, Centre for Competition Policy, University of East Anglia. Available at: <http://competitionpolicy.ac.uk/documents/8158338/8194340/Big+Switch+-+Results.pdf/2e01588d-6564-4e28-b06d-233eaad389c4>

fact that while the motor insurance market has a relatively high switching rate compared to other markets, anecdotally consumers complain about the hassle of getting motor insurance quotes every year.

Compared to motor insurance, the current FTDT proposal has the following crucial difference: non-action by the consumer does not lead to an interruption of supply, there is no situation analogous to being uninsured. It is not practical/politically acceptable for consumer inaction to lead to interruption of a household's energy supply. If the policy objective was simply to increase the switching rate one could make it more difficult and costly for a consumer to take no action, with cutting off a household's energy supply being a particularly severe consequence of inaction. However, 'forcing' an action on consumers implies imposing a cost on them and this cost will reduce their welfare. That disconnection is ruled out is important as it potentially mitigates the risk of additional switching costs being 'imposed' on consumers; it means that in the FTDT environment consumers could still choose not to switch and avoid the full costs of switching if these are excessive. Nevertheless, the FTDT proposal does encourage consumers to make an active decision not to switch and the time/effort taken to make this decision will impose an opportunity cost on consumers.

FTDT vs Evergreen tariffs

As noted above the key difference between the FTDT proposal and the motor insurance market is the continuity of supply when no action is taken. We agree that it is critical to retain the continuity of supply element of the FTDT proposal due to all the negative consequences of disconnection; however, continuity of supply substantially reduces the difference between FTDT and evergreen tariffs. In essence, with continuity of supply imposed, the difference between current evergreen tariffs and FTDT can be boiled down to two points: (i) a commitment to prompts to switch on at least an annual basis, and (ii) potentially increased regularity in the timing of price changes (if prices were fixed during an FTDT the proposal represents a switch to annual price changes). While these changes may be beneficial, they are less radical alterations than perhaps Centrica's and Scottish Power's submissions suggest.

Regarding (i), the crucial factor will be any additional effectiveness of the prompts to switch in the FTDT proposals relative to the customer communication elements of the RMR. Also, it is important to note that the impact of increasing the number of prompts to action on switching rates is probably non-linear: as the number/frequency of prompts increases the resulting increase in switching rates is likely to decrease. Intuitively it seems plausible that quarterly or six-monthly calls to switch may be viewed as 'junk mail/spam' which, at best, consumers ignore and, at worst, consumers view as a nuisance. As a result, as well as being ineffective, such frequent calls to action might represent a reputational risk to whichever body imposed them. Increased consumer communications prompting consumer action will also involve a direct cost to firms which will need to be recovered from consumers. Nevertheless, an annual prompt to switch seems broadly proportionate.

The other point regarding communication is that a transition from evergreen to FTDTs would represent a clear opportunity for an industry wide communication campaign to encourage switching. Such a campaign is likely to deliver a one-off increase in switching, but its long-term impact is potentially questionable. In considering the proposals, the longer the switch from evergreen to FTDT is staggered across consumers the weaker the impact a concerted marketing campaign may deliver as only some consumers will be able to act on the campaign message at any particular point in time.

Regarding (ii), a priori it is difficult to know whether regularising the timing of price changes is beneficial or harmful. If Centrica's proposal for variable pricing within an FTDT is followed, so that

prices can be changed at any time, there seems to be minimal difference between the pricing strategies that are likely to be employed between an FTDT and an evergreen tariff. Indeed, introducing the term 'fixed' into the naming of the product, but leaving prices variable could lead to significant consumer confusion. If prices were only allowed to change at the end of the fixed term, i.e. annually, two alternative scenarios are possible: (a) competition is focused on specific points in time and is more intense, or (b) it helps suppliers co-ordinate price changes and competition is weakened. We recommend that, if FTDTs are taken forward, the choice between fixed and variable pricing is the subject of serious thought, including a review of the research in this area. As with (i), the impact of (ii) is likely to be influenced by how staggered or concentrated the switch from evergreen tariffs to FTDTs is, since this will determine the proportion of consumers that will be coming to the end of a fixed term, and potentially subject to a price change, at any point in time. If all tariffs changed in a particular time 'window', consumers might feel more confident that they had received a good deal as the risk of 'better' deals appearing soon after consumers have taken their decisions is removed. However, to require companies to change their prices at particular specified times seems very intrusive and might pose logistical challenges regarding the volume of consumer switches occurring in a short period of time.

Responses to Selected Questions

(a) It is likely that the FTDT proposals will lead to increased engagement to some extent, however, it is difficult to determine how large this increase in engagement will be. Moreover, as we have discussed above, engagement should not be considered an end in itself, increasing consumer/total welfare is the correct objective against which to assess any remedy.

(a) (i) It seems likely that the responsiveness to the end of fixed term notifications reported by Centrica and Scottish Power is influenced by the fact that the consumers currently on fixed term contracts have a higher innate propensity to switch compared to those consumers who remain on SVTs. Analogous to prior switching behaviour in the energy market, both Flores and Waddams Price (2013) and Waddams Price and Zhu (forthcoming) find that switching behaviour in markets other than energy influences switching behaviour within the energy market. To understand the potential impact of prompts on consumers switched to FTDTs it seems sensible to review experience/research looking at the responsiveness of SVT consumers to different communications.

(b) When assessing the effectiveness of the remedy in 'protecting' those consumers who fail to engage, the alternative needs to be clearly specified. If suppliers have total freedom in setting the prices of the FTDT, it is difficult to see why those who do not engage in the market would be more protected than under the present arrangements involving evergreen tariffs. Indeed, if FTDTs led to increased switching, the 'rump' of non-engaged consumers may be, on average, stickier than non-engaged consumers presently on SVTs, a rational company could respond to this by charging a higher price for the FTDT than today's SVTs.

If the alternative is a safeguard tariff, whether the FTDT offers more protection depends on the level of the safeguard tariff. Unless the 'headroom' incorporated into the safeguard tariff is large, it would seem likely that a safeguard tariff would provide greater protection to non-engaged consumers than FTDTs. However, this does not mean a safeguard tariff should be adopted, due to the other potential negative consequences of a safeguard tariff which we have outlined in our earlier response⁴. Since the

⁴ See Catherine Waddams, Morten Hviid and David Deller CCP consultation response to 'Competition and Markets Authority: Energy market investigation – Notice of possible remedies', 5 August 2015

safeguard tariff will need to incorporate 'headroom' even the protection of the safeguard tariff is, in a sense, partial. Yet there is a real danger that the safeguard tariff may disengage even more consumers, who will feel that the authorities are looking after them despite the only partial protection. Moreover a safeguard tariff could well become a focal point within the market, and may facilitate co-ordination in the prices offered to the more active part of the market.

(d) It is likely that Ofgem will need to be closely involved in the design of the prompts to action as suppliers have a clear incentive to minimise, rather than maximise, switching. However, we would advise Ofgem to consult widely on the design of the prompts and listen to suppliers' suggestions, since commercial organisations are likely to have a much better idea of how to stimulate consumer action than a regulator.

(e) On the face of it would seem desirable that FTDTs involve a fixed price as well as a fixed term for two reasons: (i) consumers are likely to value the certainty of a fixed price, and (ii) without a fixed price FTDTs seem very similar to existing evergreen SVTs. However, before any decision on fixed vs variable pricing is taken a substantive review of the evidence on this topic is needed. Among other things an assessment needs to be made about how suppliers are likely to respond to an inability to adjust prices in response to cost shocks during the life of an FTDT. We would expect prices to rise if the company rather than the consumer is bearing the risk of any cost increases; although the impact on consumer welfare of reduced uncertainty but higher prices is unclear. The total welfare impact is likely to depend on whether energy firms or consumers are better able to manage the cost shocks that can drive energy price changes.

(e) (i) It seems sensible that the default tariff should vary by payment method, region and meter type to reflect the varying costs between different consumer groups. However, to allow differences in the default tariff between consumers within each of these groups would seem to go against the notion of the tariff being a 'default'.

(ii) Allowing the default tariff to vary by payment method, region and meter type would seem to match the current situation regarding variations in SVTs.

(f) (i) and (ii) We have no comments to add other than that a concentrated marketing campaign coinciding with a switch from evergreen to FTDTs over a short time period likely to have a greater impact with consumers.

(iii) We have serious concerns about any transfer of contact details between suppliers without the explicit permission of consumers. On the face of it, requiring firms to transfer contact details for subsequent marketing efforts without explicit permission would seem likely to break data protection laws. The Information Commissioner's earlier response to the CMA's proposed remedies document seems fairly clear in this regard. Unless consumers have opted into additional marketing contact from suppliers, it seems likely that additional marketing material will be disliked by consumers. Once again we caution against the CMA pathologising non-engagement as a 'bad' behaviour to be altered, doing so would seem to go against all notions of consumer sovereignty and markets involving free choice.

(g) We advise against the wording 'emergency tariff' in the strongest terms, imposing this wording would involve Ofgem (or any other body) lying about the actual consequences of non-engagement. This would leave Ofgem open to significant reputational risks. That questions need to be included regarding "potential distress to customers" indicates that this particular proposal should be rapidly dismissed.

- (h) Monitoring the proportion of customers on FTDTs, their average tenure and FTDT pricing would seem very sensible, however, publishing the pricing data could pose risks to competition.
- (i) Yes, all suppliers should face the same conditions.
- (j) As previously noted, we are less concerned about the ability of suppliers to circumvent FTDTs than that in their practical operation they may be little different to the evergreen tariffs that already exist.
- (k) Yes, the main risks would appear to be: (i) that by regularising the points at which price changes occur FTDTs might enable some degree of co-ordination in suppliers' pricing strategies, and (ii) logistical challenges emerge regarding the switch to FTDTs which might affect companies asymmetrically or lead to negative publicity/a drop in consumers' confidence in the energy market.
- (m) As discussed above, the CMA should give due regard to the additional switching/decision costs that may be incurred by consumers as a result of the switch to FTDTs. The CMA should also consider any additional operational costs imposed on firms as a result of the switch to FTDTs.
- (o) If the CMA decides that FTDTs genuinely benefit consumer/total welfare they should choose an implementation strategy that guarantees FTDTs will be introduced. Merely recommending FTDTs does not seem to provide such a guarantee.