Appendix 11.1: Assessment of the impact of domestic retail remedies on detriment

Contents

Introduction

1. This appendix sets out our assessment of the likely impact of our retail remedies package on the detriment suffered by domestic retail customers. Its focus is on the detriment arising from the Domestic Weak Customer Response AEC, the Prepayment AEC and the RMR AEC.[1] We estimate that the detriment arising from these AECs is very substantial – at around £1.4 billion a year over the last three and a half years, and around £2 billion in 2015.

2. Our remedies package has three strategic components: creating a framework for effective competition; helping customers to engage; and protecting those customers less able to engage to exploit the benefits of competition. As explained in Section 11, the remedies will work together as a package and there are important interactions between different components of the package.

3. In this section we assess the extent to which and the timescales over which our remedies are likely to reduce detriment. We consider two broad categories of domestic customer, differentiated according to their method of payment:

   (a) Customers who pay by direct debit or standard credit (or "non-prepayment customers"); and

   (b) Prepayment customers[2].

4. In the rest of this appendix we:

[1] We also consider separately the detriment arising from the settlement AECs, while noting that our remedies to improve the settlement system are also likely to have an impact on customer engagement.
[2] Customer on restricted meters fall into both categories.

(a) set out the timescales for the implementation of our remedies for both categories of customer;

(b) review the available evidence on the likely impact of our remedies for non-prepayment customers, which primarily consist of measures to improve customer engagement; and

(c) assess the evidence on the likely impact of our remedies for prepayment customers, considering first the likely impact of measures in the absence of the price cap, and then the impact of the full set of remedies including the price cap.

5. Our intention in this document is not to produce a formal forecast or impact assessment, but, rather, to set out the analysis that has informed our view of the appropriate package of remedies and of the timescales over which we would expect them to take effect in reducing detriment.

Timescale for implementation of remedies

6. Section 15 sets out a detailed assessment of the timescales over which we would expect individual remedies to be rolled out. Drawing on this analysis, we have assessed when different components of the remedies package will start to take effect in reducing detriment.

7. For non-prepayment customers, our expectation is that remedies will be in place to address the features and/or reduce detriment from the Domestic Weak Customer Response AEC according to the following timetable:

(a) In 2017, we expect aspects of the simpler choices component of the RMR rules to be formally withdrawn and the new standard of conduct in place (we note that in April 2016 Ofgem informed suppliers of its intention to deprioritise enforcement action in relation to this component of the RMR rules); the reforms to increase the incentives and ability of TPIs to improve customer engagement will all be in place; and suppliers will start allowing all customers on restricted meter tariffs to switch to their single-rate unrestricted meter tariffs without such switch being conditional on changing meter, and informing them of their ability to do so.

(b) In 2018, we expect suppliers and Ofgem to be able to access the database of Disengaged Domestic Customers who had not opted out, which will be updated every month, and, towards the end of the year the first intervention from the Ofgem-led programme to be implemented.

(c) In 2019, we expect further interventions arising from the Ofgem-led programme to be progressively implemented.

(d) In 2020, mandatory half-hourly settlement is likely to be in place for domestic customers.

8. The above remedies will also apply to prepayment customers. In addition for such customers, by the beginning of 2017 we expect gas prepayment tariff codes to be reallocated and SLC 22B.7(b) to be amended, helping to alleviate some of the supply side constraints to which they are subject.

9. We also note that other changes will be taking place that will be expected to improve aspects of domestic retail market competition over the next few years, including notably the roll-out of smart meters (expected to be available to all domestic customers by 2020) and the introduction of next day switching, expected in 2019.[3] We also note that the design of our price cap (specifically the exclusion of SMETS 2 meters from the scope of this remedy) incentivises suppliers to prioritise the roll out of smart meters for prepayment customers.

Impact of domestic retail remedies on non-prepayment customers

10. For non-prepayment customers, who represent the majority of domestic customers, the key to addressing the Domestic Weak Customer Response AEC and reducing detriment is by improving engagement. We consider that a more competitive outcome for these customers, who are not subject to major supply side issues can be achieved by increasing the intensity and success with which consumers engage in the market. The former is about how many customers engage in the market, and the frequency with which they do that. The latter concerns the outcomes that consumers achieve through their engagement in the market (i.e. whether they move to a better deal). Both are needed for consumers to exert sufficient pressure on suppliers in order to ensure that competition overall is working well, and not only for some parts of the market.

11. In this section we explain how we expect our remedies to improve engagement along those two dimensions. First, we review relevant historic trends in order to inform our expectations as to what progress on engagement is achievable and over what time frame. We then set out the anticipated outcomes from our remedies, and discuss how various parts of our remedies package will help deliver these outcomes. Finally, we set out the potential reduction in detriment that we might expect to see over the next few years.

[3] https://www.ofgem.gov.uk/sites/default/files/docs/2015/02/fast_and_reliable_switching_decision_final.pdf

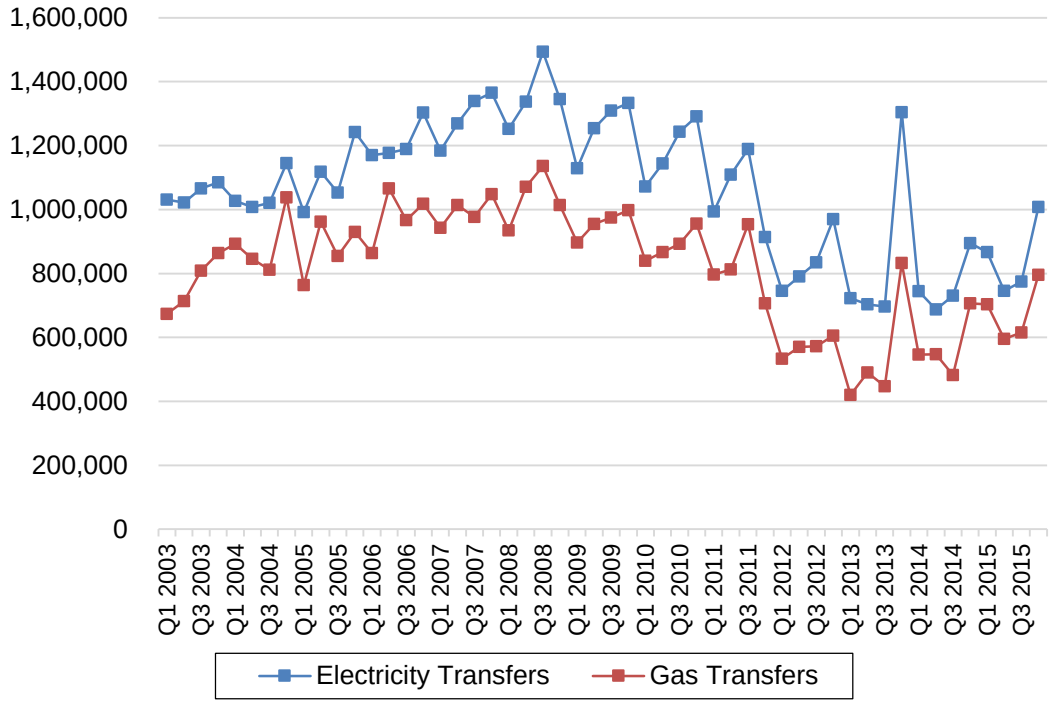
Lessons from the history of domestic retail market competition

12. In this section we review historical trends in a variety of aspects of engagement in the domestic retail markets, including switching rates, the relationship between tariffs and costs and the accuracy of switching behaviour, in order to inform our expectations as to what progress on engagement is achievable and over what time frame.

Rates of switching

13. The figure below shows data on quarterly switching numbers published by DECC.

Figure 1: Quarterly domestic electricity and gas transfers in Great Britain



Source: DECC, Quarterly Energy Prices, March 2016.
Notes: Transfer statistics refer to the number of customers switching from one energy supplier to another. For electricity and gas (from January 2014) this includes all suppliers. For the period prior to January 2014, gas transfer statistics only cover the Six Large Energy Firms.

14. The figure above shows that, from 2003 - one year after the markets were fully opened to competition - until about 2008/09, there was a steady upward trend in gas and electricity switching rates. At their peak in 2008, the switching rates for gas and electricity reached 19% and 21%, respectively, resulting in approximately 10 million transfers. This is substantially higher than the current switching rates (12% for both gas and electricity), and the annual switching rates in many other markets, such as fixed broadband (11%), fixed line

telephony (11%), mobile telephony (10%), pay-TV (7%)[4] and personal current accounts (3%).[5]

15. The data shows that in the period between 2005 and 2008, the number of transfers increased by 20%. There is also a very noticeable spike in switching towards the end of 2013, which may have been due to the high level of political controversy surrounding energy prices at that time, one of the contributory factors leading to this investigation.[6]

16. We consider, as explained in Sections 8 and 9, that the reduction in switching since 2008/09 is unlikely to be indicative of any saturation threshold that might have been reached, but is likely attributable to the prohibition of regional price discrimination in 2009, and companies' decisions to stop doorstep selling in 2011 following a period of intense enforcement activities by Ofgem against mis-selling.

Cost pass-through

17. In Section 8 we reviewed the evidence on cost pass-through – the extent to which changes in costs are passed through into changes in domestic retail prices. In a well-functioning market we would generally expect prices to reflect marginal costs, and this in turn will give efficient signals to market participants about consumption and production decisions, rather than historical costs (which are sunk).

18. The Figure below shows the relationship between the average price of the standard variable tariff (based on the annual bill for a dual fuel direct debit typical consumption customer) offered by the Six Large Energy Firms and the one-year cost benchmark, which tracks the cost that a supplier would incur if it were to purchase energy for a typical customer for the following 12 months, based on the prevailing energy prices in that month in the market.

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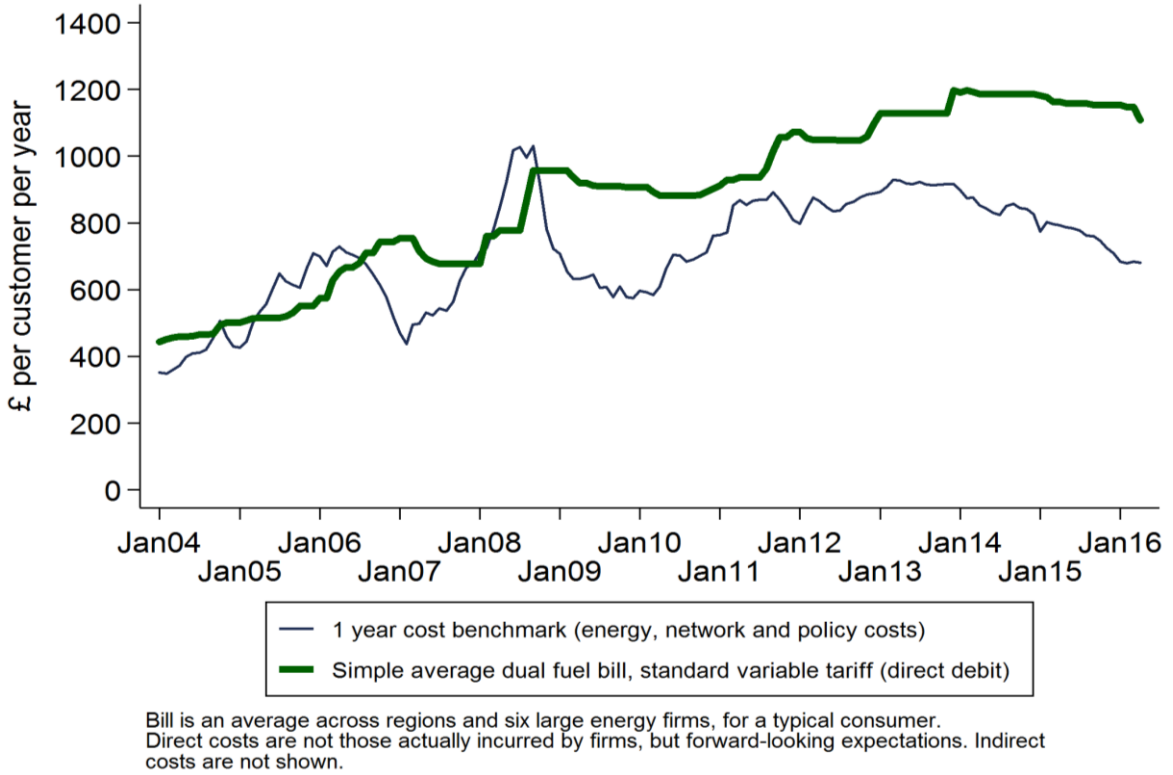
[4] Based on Ofcom Switching Tracker, see Ofcom (2016), The Consumer Experience 2015. We note that these figures include home moves. In addition, we note that this survey estimated switching rates of gas and electricity of 15% and 16% respectively (see Figure 30 in Research Annex of The Consumer Experience 2015). These are higher than our figures for gas and electricity, both 12%, which are based on actual switching as measured by DECC and this suggests that this survey may overestimate switching.

[5] A customer survey commissioned by the CMA as part of its banking market investigation found that in 2014 only 3% of personal current account customers switched their personal current account to a different bank in the last year. See CMA (2015), *Retail market banking investigation: summary of provisional findings report.*

[6] See paragraph 1.1 of Ofgem's Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain.

Figure 2: Average direct debit SVT price (based on the annual bill for a dual fuel typical consumption) and a forward-looking industry-level benchmark of direct costs



Source: CMA analysis of data collected from the Six Large Energy Firms, Ofgem and ICIS.

19. The gap between the measures of direct costs and the average standard variable tariff widens over time, from around 2009 onwards. The gap narrows somewhat in 2011, with increases in wholesale gas costs, but then increases again from 2014 as reductions in wholesale gas costs are not passed through into commensurate reductions in the standard variable tariff. In contrast, the cheapest non-standard tariffs have tracked changes in expected direct costs more closely.

20. The evidence appears to be consistent with a weakening of competition over the standard variable tariff over time. This is particularly apparent from 2009 which broadly coincides with the introduction of the prohibition on undue regional price discrimination. The withdrawal of the Six Large Energy Firms from doorstep selling in 2011 and 2012 may have also contributed to this pattern. And, as discussed further below, the more recent introduction of the RMR reforms is likely also to have dulled the incentives and reduced the ability of suppliers to engage long-term disengaged customers.

21. Our assessment of excess profitability in the domestic retail markets shows a broadly similar trend, as discussed in more detail in Appendix 9.10. Over the period 2007 – 2009, the Six Large Energy Firms made an average annual economic loss (ie returns below the cost of capital) of £125 million, while over

the period 2010 to 2014 they made an average annual profit (ie returns in excess of the cost of capital) of £560 million.[7]

Evidence on the benefits from switching

22. Looking at the evidence on the benefits for consumers arising from engaging in the markets, we note the following:

    (a) Evidence collected by Ofgem as part of the Energy Supply Probe in 2008 showed that approximately 40% of consumers that had switched did not succeed in reducing their bill;[8] and

    (b) Academic research by Waddams and Willson (2006)[9] showed that between 27% and 38% of electricity consumers across two surveys conducted in 2000 and 2005 actually lost surplus as a result of switching; and that, in aggregate, switching consumers appropriated only half of the maximum available to them.

23. It was in response to such concerns that Ofgem introduced the RMR rules. These were designed to help customers understand the range of choices available to them, and therefore make informed decisions leading to better outcomes.

24. Our customer survey provides more recent evidence (2014) suggesting that, for some customers, achieving anticipated savings is still an issue, albeit not at the scales identified above. In our survey 16% of customers (who estimated likely savings when switching) felt that savings achieved by switching were lower than expected.[10] And of those, 70% thought that switching had had no or a negative impact on their bills.[11]

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[7] We note that there is not a simple, stable relationship between the gap identified in Figure 2 and realised profitability, due largely to the impact of weather on levels of domestic consumption of gas and hence profits from sales of gas. As shown in Figure 2.9 in Section 2, domestic gas consumption was particularly low in 2011 and 2014, which would tend to reduce levels of profitability from gas sales in those years, while it was particularly high in 2010, which would tend to increase levels of profitability from domestic gas sales. Further, Figure 2 shows only the relationship between costs and the SVT, and so excludes around 30% of the customers of the Six Large Energy Firms.

[8] Ofgem used a survey conducted on their behalf by Ipsos MORI in June/July 2008 to identify whether specific consumers who switched supplier achieved a better deal. It is based on the change in the average bill that a consumer in particular region would have observed from their actual switching behaviour. Using average bills (instead of actual bills) allows inference of actual consumer experience in larges samples. Further detail is contained in Ofgem's Energy Supply Probe – Initial Finding Report https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf

[9] http://else.econ.ucl.ac.uk/conferences/consumer-behaviour/wilson.pdf

[10] CMA survey, derived from question E39, base = 1,584.

[11] CMA survey, derived from questions E39 and E40, base = 223.

Summary

25. Caution is always required in interpreting historical evidence, as a range of factors are likely to drive observed outcomes. However, we can draw some broad conclusions from the evidence presented above:

    (a) Customers can be encouraged to engage in the energy markets in relatively large numbers (10 million transfers in 2008; switching rate at its peak has been higher than in some other large service markets) and significant growth in engagement can be achieved over a relatively short time-frame (e.g. 20% growth over the period 2005-2008);

    (b) The rate of switching has fallen since 2009 and its current level (12%) is low by historic standards and leaves considerable room for upside potential within a short period of time;

    (c) There has been a widening gap between measures of direct costs and the average standard variable tariffs from around 2009 onwards, which broadly coincided with several important changes in the regulatory and commercial environment, such as the introduction of the prohibition on undue regional price discrimination in 2009 and the withdrawal of the Six Large Energy Firms from doorstep selling in 2011 and 2012.

    (d) Consumers switching to a tariff that is potentially more expensive than their previous tariff was a legitimate concern at the time of the introduction of these regulatory reforms in 2009 and is still a problem for some customers.

Expected outcomes from our remedies

26. In this section we set out four types of expected outcome from our remedies, which we consider will serve, in combination, to improve engagement from domestic customers and reduce the detriment arising from the Domestic Weak Customer Response AEC. These are:

    (a) improved engagement through regulatory interventions informed by robust evidence;

    (b) intensified competition between suppliers for disengaged customers;

    (c) expanded role of TPIs and data; and

    (d) higher customers benefit arising from engagement.

Improved engagement through regulatory interventions informed by robust evidence

27. First, our remedies will help ensure that future regulatory interventions to improve engagement are based on robust evidence. We noted in Sections 8 and 9 that, for the majority of domestic customers, shopping around and switching is relatively easy - yet many of these customers have never considered engaging. This suggests that, for such customers, barriers to engagement may be partly behavioural in nature. The key to unlocking engagement from such customers may be relatively simple – the way in which information is framed or the medium of communication, for example – but is likely to differ between types of customer and over time. Our approach to improving engagement for such customers reflects this in that – in contrast to many previous interventions in the past – it is based on the use of robust evidence from trials and testing (including, where appropriate, randomised controlled trials) to identify what works in practice.

28. Many past interventions have been based largely on *a priori* reasoning, with little attempt to test hypotheses systematically through rigorous trials or other forms of testing before the intervention was implemented. *A priori* reasoning can provide useful insights into the sorts of interventions that may help, but rigorous evidence is needed to ensure that only those interventions that are most likely to make a difference for given customers at a given point in time are implemented.[12] The Ofgem-led programme is therefore essential to ensure that future interventions are based on what works in practice.

29. Further, Ofgem will be able to use the database of disengaged customers to assess the effectiveness of different interventions. The database, which could contain the records of up to 10 million customers,[13] will provide Ofgem with an extremely powerful tool for assessing the impact of different interventions and forms of communication with disengaged customers.

Intensified competition between suppliers for disengaged customers

30. Second, our remedies will serve to **intensify competition between suppliers** to access and engage disengaged customers, by: reducing the

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[12] We have ourselves identified some proposals for increasing customer engagement, such as providing customers with information on the cheapest tariffs in the market, or changing the name of the default tariff, which we recommend should be subject to trials. If the evidence from such trials suggests that a particular initiative will not work, it should be rejected.

[13] To calculate this figure we use data as at Q2 2015 on the total number of electricity customers in Great Britain (27.4 million customers), the share of electricity customers at the Six Large Energy Firms (89.6%), by the percentage of customers on an SVT at the Six Large Energy Firms (71.5%) and the percentage of customers who have been on an SVT with the same supplier from the Six Large Energy Firms for more than three years (55.1%). We note that this is an upper bound estimates as for three suppliers the data provided on the percentage of customers who have been on that supplier's SVT for more than three years was based on the length of the relationship with the supplier rather than the length of time on that supplier's SVT.

costs of identifying and communicating with such customers (the Database remedy); and by amending elements of the regulatory framework to increase the incentives of suppliers to engage these customers (the withdrawal of the simpler choices component of the RMR rules and settlement reform).

Reducing the costs of communicating with disengaged customers

31. As set out in Section 9, our survey provides evidence on what are the defining characterises/circumstances of disengaged customers that may explain why they do not engage in the market. For customers on standard variable tariffs who have not switched in the last three years, which we consider to be a core group that needs to be encouraged to engage, the evidence shows that there are sizeable barriers (actual or perceived) to them engaging in the market on their own initiative, including via PCWs. For instance, our survey shows that of those customers: 21% do not have access to the Internet;[14] and 51% either do not have access to the internet or are not confident that they would be able to get a right deal using PCW.[15]

32. Our Database remedy will prompt customers to engage and address the barriers to accessing and assessing relevant information, and in particular provide an alternative channel for engagement for those who cannot, or have been reluctant to engage through PCWs. It will:

    (a) allow Ofgem to contact those customers and inform them about their rights to switch, the ways in which switching can be done, and about opportunities in the market to make savings from switching; and

    (b) allow rival suppliers to contact those customers directly and try to incentivise them to switch.

33. The evidence from doorstep selling suggests that potentially a large number of customers could be incentivised to engage through direct marketing. An important point to note, which is discussed below in more detail, is that our Database remedy has been designed in a way that will allow Ofgem to have oversight over suppliers' communication with the disengaged domestic customers on the database and will otherwise be in control of the process. This will minimise the risk of suppliers misleading customers and engaging in the sorts of practices that brought doorstep selling into disrepute (see Section 13 for further discussion on this point).

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[14] CMA survey, derived from questions H1 and excludes those who answered 'Don't know', base = 3,162.
[15] CMA survey, derived from questions H1 and H3 and excludes those who answered 'Don't know' to either question, base = 3,107.

34. A particularly important aspect of our Database remedy is that it will provide the Mid-tier Suppliers with a cost effective route to reach disengaged customers. This is an area which provides them with substantial growth opportunities but in which they have not been particularly successful so far.[16] The evidence set out in Chapters 9 and 10 suggests that Mid-tier Suppliers offer some of the most competitive tariffs in the market, and that their customer service levels compare favourably with the Six Large Energy Firms. As such, they would be an attractive proposition for many disengaged customers, particularly those who require large gains in order to engage in the markets.

Amending the regulatory regime to improve incentives and ability to engage customers

35. In relation to the regulatory regime, past experience suggests that customer engagement in the domestic retail energy markets can be improved where suppliers have the incentives and ability to do so. For example, as noted above, switching rates in 2008 reached around 20% (compared to the current levels of 12%), through a combination of offering out-of-area discounts on standard variable tariffs and accessing otherwise-disengaged customers through doorstep selling. Our evidence on costs pass-through suggests that, at the time, there was a much lower margin between the standard variable tariffs and forward-looking measures of direct costs.

36. Since then, a variety of regulatory interventions have served to soften competition - including SLC 25A, enforcement action by Ofgem leading to the abandonment of doorstep selling by most suppliers, and, more recently, certain RMR rules - coinciding with an overall fall during the period in switching rates and an increase in the gap between the standard variable tariffs and direct costs.

37. Our recommendation to remove certain aspects of the RMR rules will help to reinvigorate competition, by allowing suppliers to introduce the sorts of incentives and discounts to retain and acquire customers that will allow them to increase engagement. In particular, we are recommending that the following provisions be withdrawn.

    (a) The requirement that all tariffs are available to new and existing customers – which raises the cost to suppliers of offering discounted

[16] First Utility told us that they trialled doorstep selling trying to explain the benefits of smart meters but they found that customer acquisition costs were too high. They ran such sales for six months, analysed the results and felt it was not economic going forward.

tariffs aimed at encouraging the customers of rival suppliers to switch, particularly in combination with the Cheapest Tariff Messaging requirement[17], which requires all suppliers to communicate their cheapest tariff to all existing customers.[18]

(b) The restrictions on discounts that prohibit one-off discounts – which could be used to prompt/encourage customers to switch. Any discounts must currently be offered to customers on all tariffs and may only relate to dual fuel, online or dividend discounts.

(c) The four tariff rule - which creates an opportunity cost to launching a tariff designed to attract particular groups of customers. These might be a very competitively priced tariff with particular requirements around how a customer manages their account or a tariff that offers certain rewards.

38. Crucially, however, and as discussed further below, our remedies will also address the concerns about customer confusion and poor decision making that led to the initial introduction of these regulations. In addition, Citizens Advice have recently launched their own price comparison service that can be accessed on-line or face-to-face in local Citizen Advice centres.

39. In the longer term, settlement reform will both expand the role of suppliers and change their relationship with their customers. Whereas currently, suppliers have a financial incentive to keep their existing customers disengaged, this will no longer be the case for all their customers when they are charged according to their customers' actual consumption profile. Wholesale electricity prices are expected to be more volatile in the future, such that suppliers will face a strong price signal to encourage their customers to shift consumption to cheaper periods.

Expanded role of TPIs and data

40. Third, our remedies seek to harness the incentives and enhance the ability of TPIs to unlock customer engagement and to exert competitive **pressure on energy suppliers,** by giving them greater access to the data they need to

[17] While we are not recommending that Ofgem removes the Cheapest Tariff Messaging requirement as part of our recommendation to remove certain aspects of the RMR rules, we recognise that removing the requirement that all tariffs are available to new and existing customers means that suppliers could avoid showing their existing customers their most competitive tariffs offered to new customers only.
[18] As explained in Sections 9 and 12, recent experience in relation to white label suppliers demonstrates the willingness of some suppliers to stop or reduce discounting if required to show all their customers their cheapest tariffs. For example, EDF told us that when suppliers were not required to display white labels in the Cheapest Tariff Messaging, there was more segmentation between existing and new customers as suppliers were able to offer cheap deals to new customers but did not have to display those deals to their existing customers.

perform this role more effectively and at a lower cost, and by removing regulatory barriers to their expansion.

41. The evidence from our survey suggests that PCWs have been fairly successful so far in helping customer to engage in the energy market. In particular, 62% of respondents who switched supplier in the last three years used a PCW for searching last time they switched.[19] Of those respondents 53% completed their switch via a PCW.[20]

42. However, we do not believe that PCWs have fully realised their potential to facilitate engagement in the retail energy markets. The evidence suggests that PCWs which are also present in markets other than energy spend a relatively small proportion of their advertising expenditure on their energy comparison and switching services (less than 15% of their total advertising spend in 2014, see Appendix 9.3). We estimate that in 2014 PCWs spent approximately £32 million on advertising their energy comparison and switching services. This is significantly less than the advertising spent by PCWs on private motor insurance (see figure below), which we consider to be a particularly good example of a market where PCWs have been successful in driving customer engagement (the switching rate in the private motor insurance market is 35%).[21]

43. The data in Figure 3 below shows that in 2012 PCWs spent approximately £150 million on advertising their services in private motor insurance which is almost five times the amount they spent on energy comparison services in 2014. This despite the fact that private motor insurance is a considerably smaller market than the domestic retail energy markets.[22] These data also show that there is a very high correlation between PCWs advertising spend in the motor insurance sector and their customer acquisitions, and that PCWs increased their customer acquisitions by roughly 60% between 2008 and 2012:

[19] See Appendix 9.1.
[20] See Appendix 9.1.
[21] We note that one reason why switching may be higher in private motor insurance than in retail energy markets due to the differences in the end of contract process. In particular, at the end of a private motor insurance contract a customer has to actively acquire a new insurance contract (either with their current or a new insurer) as if they do not they will no longer be insured. In contrast, regulations governing energy supply ensure that domestic customers generally receive continuous supply of gas and electricity such that, for example, at the end of a fixed term contract in the energy market a customer that does not actively choose a new tariff (either with their current or a new supplier) will still be provided electricity and SVT have no end date. This implies that, when compare to private motor insurance, there is no natural trigger point for engagement.
[22] Roughly a third of its size (Source: CMA Private Motor Insurance Investigation: Final Report).

Figure 3: Advertising expenditure and sales volume by the big four PCWs in the private motor insurance sector (2008-2012)

[✂]

Source: CMA Private Motor Insurance Investigation: Final Report.
Note: Sales volume data for Comparethemarket is based on the closest accounting year rather than the calendar year.

44. We note that Ofgem's Confidence Code requires PCWs to use all reasonable endeavours to include price comparisons for all domestic tariffs available in the market. In no other market are PCWs required to do this. We consider that this whole-of-the-market requirement could be damaging to the incentives of PCWs to participate in the domestic retail energy markets. Recent changes to the requirement (which prevent PCWs setting as a default display results for suppliers with whom they have a commercial relationship) appear to have resulted in fewer suppliers paying PCWs commission rates.

45. We are introducing a set of remedies which are intended to increase both the ability and incentives of PCWs to intensify their activities in the domestic retail energy markets. In particular:

(a) We are removing certain regulatory restrictions in order to increase their incentives to invest in the domestic retail energy markets (the 'Whole of the Market Requirement' from the Confidence Code) and to compete on price (the RMR rules which prevent suppliers from being able to offer tariffs exclusively via a particular PCW).

(b) We are introducing measures that would allow PCWs to have better control over the switching process (through access to the ECOES and SCOGES databases). This will increase confidence with which customers view switching through PCWs.

(c) We are recommending to DECC several changes to the Midata programme that would give PCWs increased access to customers' data. This will enhance PCWs ability to monitor the market on behalf of their customers and alert them of potential savings available to them. It will also provide them with an opportunity to take advantage of their technical capabilities to develop innovative solutions to engage customers.

46. Our remedies will therefore increase the incentives of TPIs more broadly to be active in the retail energy markets and, by giving TPIs greater access to data, allow them to continue to grow in importance, lowering acquisition costs for suppliers and lowering search costs for customers. While PCWs are the most common type of TPI currently, TPIs are taking a variety of forms that are likely

to appeal to different demographic groups: some, such as Flipper[23], which offers an automated switching service, may radically reduce the hassle of switching for those who sign up while others, such as collective switching services advertised through a variety of media, may appeal more to customers who are less confident in using the internet and therefore will be of particular value in accessing the long-term disengaged.

47. We expect that following implementation of these remedies there will be a substantial increase in TPI activity in the domestic retail energy markets.

Ensuring customers benefit from engagement

48. Finally, we note that increasing customer switching is not an end in itself. Our aim is to ensure that customers benefit from increased engagement – ie that it results in them being on good deals for them. In this respect we acknowledge that some of the regulatory interventions discussed above – notably enforcement action by Ofgem against the misuse of doorstep selling - were motivated by a legitimate concern that in the absence of intervention, customers may be persuaded to switch to deals that would leave them worse off.[24]

49. If customers fail to identify tariffs that allow them to gain from switching, this may reduce their willingness to engage in the market again. If many customers are in that position, these are likely to generate negative publicity which will further discourage engagement. It also suggest that such customers do not impose an effective constraint on suppliers' pricing policies, which is needed to improve competition, even when they switch in relatively large numbers.

50. Consumers can make suboptimal switching decisions (this includes a decision not to switch when gains are available) because they make a genuine decision error on the basis of the information that is available to them, or due to the pressuring or misleading influence of suppliers or TPIs. Some of our remedies are designed to help customers to access and assess relevant information, which in turn should reduce the risk of ineffective switching.

51. We note that misleading influence of suppliers on customers through direct marketing has been a significant problem in the past and in particular in relation to doorstep selling where Ofgem took enforcement action against each of the Six Large Energy Firms for misleading marketing activities. While

[23] https://flipper.community/about
[24] The evidence we review in Section 13 provides some support for this belief.

taking enforcement actions appears to have succeeded in reducing inappropriate behaviour by suppliers, it has taken a long time to achieve this.

52. We expect that there will be a substantial increase in suppliers marketing activities towards disengaged customers as a result of our database remedy, but our remedies will place Ofgem in a much better position to prevent misleading marketing activities from taking place, and if they do occur, to deal with them promptly. As set out in Section 13, we would expect Ofgem to test aspects of the marketing correspondence (eg content and frequency) being sent by rival suppliers to prompt the Disengaged Domestic Customers that have not opted out of the Database remedy in the context of the Ofgem-led programme. We expect Ofgem will also be in a position to monitor the communication from suppliers to customers and to take action promptly in response to malpractice. Lastly, Ofgem will be in control of the database and will be able to deny suppliers access if the marketing activity is not in customers' interest.

53. We believe that the creation of an Ofgem-controlled database of disengaged customers will be far less prone to abuse than doorstep selling, because Ofgem will have powers to exclude suppliers from accessing the database if misleading information is given to customers and it will be charged with continual monitoring of the effectiveness of the database, to establish which forms of communication from suppliers genuinely help engagement in the interests of customers.

54. The Ofgem-led programme would also be used to identify through robust testing the most appropriate form of information received by domestic customer from suppliers. This should reduce or minimise the complexity of those communications, and provide such customers with information that would prompt them to switch and help them to make an accurate decision in relation to the various options available to them.

55. As part of this programme, we are recommending that Ofgem test the case for market-wide tariff messaging on bills, which could provide customers, particularly those who do not use PCWs, with a valuable source of information on the cheapest tariffs available in the market. We note that such an approach would avoid the disadvantages identified above relating to the current Cheapest Tariff Messaging requirements, which relate to the supplier's own tariffs, and hence dull incentives to offer cheap tariffs to new customers.

56. Other aspects of our remedies package seek to improve customer understanding and avoid the risk of confusion without undermining competition in the way that previous interventions have done. For example, in conjunction with our recommendation for the removal of aspects of the RMR

rules, we are recommending the introduction of a new principle requiring tariffs to be readily comparable. And in relation to TPIs, our remedies will help ensure clarity over market coverage rather than, as at present, all PCWs advertising all deals whether they receive a commission or not, undermining their incentives to operate in the markets.

Potential reductions in detriment from improving engagement

57. Our overall package of remedies to improve engagement will give suppliers and TPIs greater ability and incentives to engage customers and ensure customers have the information they require to make an informed choice. Combined with the changes that will be brought about through the full roll-out of smart meters, the move to next day switching, and ever-easier access to information facilitated by improvements in IT, we believe that our remedies will bring about a major improvement in customer engagement.

58. We believe that the benefits of our remedies will be seen in part through a reduction in the gains from switching that go unexploited by customers. However, crucially, this would not be achieved by a levelling up of prices (a potential risk of regulatory interventions that seek to constrain price differences) but by a gradual reduction in prices towards the competitive benchmark level, as more efficient suppliers gain customers from the less efficient.

59. As noted above, we expected certain of our remedies to start taking effect to improve engagement from 2017,[25] with our other remedies being implemented in each year over the period 2017 to 2020. We note that, in contrast to the situation for prepayment customers, for most domestic customers detriment will be reduced as soon as they engage effectively. We would therefore expect detriment to be reduced throughout the period 2017 to 2020, and in particular from 2018 as the Database remedy and Ofgem-led programme start to take effect.

60. In practice, reductions in detriment could come about through a combination of: a reduction in the proportion of customers who are on expensive tariffs (and notably the SVT, currently paid by around 70% of customers) as customers switch tariff or supplier; and a reduction in the price of expensive tariffs as suppliers respond to increased engagement. In both cases, this

[25] We note that the effect of relaxing the RMR rules is likely to be felt in 2016, as Ofgem has already announced that it will deprioritise enforcement action in relation to certain RMR provisions, following publication of our Provisional Decision on Remedies. https://www.ofgem.gov.uk/system/files/docs/2016/04/supplier_letter-removal_of_simpler_rmr_rules_14.04_0.pdf

would result in a reduction in the average price paid by all customers, and hence a reduction in detriment.

61. To illustrate the potential magnitude of impacts, we have assumed that detriment will remain constant between 2015 (the most recent year for which it was calculated) and 2016, at around £1.6bn for non-prepayment customers. While it is not possible to quantify precisely the price reduction in the next few years, we note that a fall by 3% a year from 2017 would be sufficient to eliminate the detriment by 2020. [26] If average prices could be reduced by 1% a year from 2017 to 2020 (from either of the two above effects), detriment as of 2020 would stand at around £1bn. If average prices could be reduced by 2% a year over the period, detriment would be around £500m in 2020.

Impact of domestic retail remedies on prepayment customers

62. As noted in Section 9, prepayment customers suffer from heightened features giving rise to the Domestic Weak Customer Response AEC and the Prepayment AEC, in contrast to the majority of domestic customers, who are suffering harm only from the Domestic Weak Customer Response AEC. In this section we consider the implications for the timescale over which our remedies are likely to have an effect.

Summary of competition problems affecting prepayment customers

63. Regarding the supply side, we have found that a combination of features reduce retail suppliers' ability and/or incentives to compete to acquire prepayment meter customers and to innovate by offering tariff structure that meet customers' demand. These features are as follows:

    (a) Technical constraints, which are exacerbated by certain aspects of the 'simpler choices' component of the RMR rules, that limit the ability of all suppliers, and in particular new entrants, to innovate by offering tariff structures that meet demand from prepayment customers who do not have a smart meter.

    (b) Softened incentives for all suppliers, and in particular new entrants, to compete to acquire prepayment customers due to:

        (i) actual and perceived higher costs to engage with, and acquire, prepayment meter customers compared with other customers; and

[26] For ease of illustration, we have assumed a flat percentage reduction in prices per year with respect to 2015 prices (based on information for the first two quarters only). In practice, we would expect the impact of our remedies to increase over the period, as new elements of the remedies package are introduced.

(ii) a low prospect of successfully completing the switch of indebted customers, who represent about 7-10% of prepayment customers.

64. In relation to the Domestic Weak Customer Response AEC, the evidence suggests that a higher proportion of prepayment customers are less engaged than direct debit customers (but not less engaged than standard credit customers), particularly in terms of whether they have ever considered switching or are likely to consider switching in the next three years, and their awareness of their ability to switch. There are a number of factors that may explain this:

(a) Prepayment customers face particular restrictions on accessing and assessing information about switching (including:

(i) all dumb prepayment customers face additional actual and/or perceived barriers to switching through the need to change meters to access favourable tariffs and a lack of awareness and understanding of their option to be able to change meter;

(ii) some prepayment customers face higher barriers to accessing and assessing information about switching arising, in particular, from relatively low access to the internet and confidence in using PCWs; and

(iii) in addition, indebted prepayment customers also face actual or perceived barriers to switching between different suppliers prepayment tariffs arising from the Debt Assignment Protocol.

(b) Prepayment customers include higher proportions of individuals with a range of demographic characteristics that we have found to be associated with low levels of engagement in retail energy markets, and notably: low levels of income; low levels of education; living in social rented housing; and having a disability.

(c) While the need to top up prepayment cards regularly is likely to increase awareness of retail energy markets among prepayment customers, low levels of engagement may have in part been influenced by the outcomes we have observed arising from the Prepayment AEC – notably the lower gains from switching and the confusion surrounding rights to switch when the customer has outstanding debt.

65. The overall weight of evidence supports a finding that disengagement and weak customer response is a more significant problem among prepayment customers compared with domestic customers on direct debit.

66. Reflecting these problems, our analysis of the prepayment segments, as set out in Section 8, suggests that competition is significantly weaker than in the wider GB domestic retail energy markets and that the outcomes for prepayment customers are significantly worse than those for customers in the credit meter segments. In particular, the range of tariffs available to prepayment customers is significantly more limited than those available in the credit meter segments, and the cheapest tariffs that are offered by suppliers to prepayment customers are significantly higher (even accounting for differentials in the costs to serve) than the cheapest tariffs in the direct debit segments.

Remedies for prepayment customers and timescales

67. We have adopted a range of remedies to address the competition problems facing prepayment customers. The engagement remedies we discussed above will apply to prepayment customers, as will a number of remedies relating to specific constraints faced by prepayment customers. For example, we expect by 2017 gas prepayment tariff codes to be reallocated and SLC 22B.7(b) to be amended to help address supply-side constraints imposed by tariff codes. However, we note that these technical constraints will not be fully addressed until the roll out of smart meters, which is unlikely to be substantially completed before the end of 2020.

68. In addition, as the above section demonstrates, the problems affecting competition for prepayment customers are wide-ranging and mutually-reinforcing, involving regulatory, technical and demand-side constraints. As a consequence of this, remedies to tackle these problems directly will take a longer timescale to achieve material reductions in detriment than for other domestic customers.

69. For example, we noted above that, for the majority of customers, detriment could be reduced straightaway if they could be persuaded to shop around and switch. In contrast, for prepayment customers, we expect that addressing the features and reducing detriment will involve an iterative process of greater supply- and demand-side pressures until more competitive prices emerge that customers can take advantage of. As an indication of this, we have seen an increase in activity by the independent suppliers in the prepayment segments, with substantial increases in their market share, without seeing material reductions in the prices paid by prepayment customers.

70. In light of this, and the particularly high level of detriment experienced by prepayment customers, we have decided to put in place a price cap for prepayment customers over the period 2017 – 2020, to reduce the detriment while our other remedies take effect. We have designed the cap to be

consistent with competition, in particular by allowing a certain amount of headroom and by excluding inter-operable SMETS2 smart meters from its coverage (we expect that, once a SMETS2 meter is rolled out to prepayment customers, suppliers can target such customers and engage with them as they would do with any other customer). We expect SMETS 2 meters will increase the incentives of suppliers to roll out such meters with attractive tariffs, to the benefit of prepayment customers.

Potential reductions in detriment for prepayment customers

71. As noted above, we believe that, in the absence of a price cap, detriment reduction would be slow for prepayment customers who do not benefit from a smart meter that is interoperable (ie SMETS 2 meters), such that in the early years the majority of the detriment reduction would be through the application of the cap itself.

72. As explained in in Section 14, detriment reduction from the cap would be just under £300 million a year in 2017, or a saving of around £70 per customer per year, out of a total detriment of just under £400 million a year. We would expect detriment reduction from the package of remedies as a whole to exceed this and for the impact of the cap to reduce over time, as competition picks up through our remedies and in particular through the roll out of SMETS2 meters that are not covered by the cap.