| | |
|---|---|
| **Title: Consumer Tariff Amendments (power f) - Clarify the power to make, upon a request from Ofgem, the activities of energy Third Party Intermediaries (TPIs) licensable.** | **Impact Assessment (IA)** |
| **IA No: DECC0127** | **Date:** 08/05/2013 |
| | **Stage:** Final |
| **Lead department or agency: DECC** | **Source of intervention:** Domestic |
| | **Type of measure:** Primary legislation |
| **Other departments or agencies: Ofgem** | **Contact for enquiries:** patrick.whitehead@decc.gsi.gov.uk |

## Summary: Intervention and Options

**RPC:** Green

| Cost of Preferred (or more likely) Option | | | | |
|---|---|---|---|---|
| **Total Net Present Value** | **Business Net Present Value** | **Net cost to business per year** (EANCB in 2009 prices) | **In scope of One-In, One-Out?** | **Measure qualifies as** |
| £0m | £0m | £0m | No | Zero Net Cost |

**What is the problem under consideration? Why is government intervention necessary?**

Switching sites are now the main source of information for domestic consumers to compare tariffs across the market and the importance of third party intermediaries (TPIs) as an interface between consumers and the energy companies is likely to grow with developments in collective switching and smart meters. It is important therefore that consumers are assured that the services TPIs provide are independent and the information they give is clear and accurate.

Ofgem is launching a review of the regulatory framework for TPIs, which will consider whether there is a case for a more regulatory approach to TPIs' activities to ensure that consumers are adequately protected. Government intervention is needed to clarify that Ofgem has the power to apply to licence TPIs' activities so that Ofgem is able to move quickly should its review conclude that there is a case for further regulation to protect consumers, without the risk of appeal on the basis it does not have the power to regulate TPIs.

**What are the policy objectives and the intended effects?**

The Government's objective is to provide certainty that Ofgem is able to licence TPIs' activities should it determine there is a need for further regulation. This will ensure TPIs work effectively and are trusted by consumers, which should encourage engagement and improve competition in the retail energy market.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

This impact assessment examines the costs and benefits of clarifying primary powers. The impact of any specific interventions would be examined separately in any impact assessment produced to accompany the secondary legislation if Ofgem request it. We have considered the following options:

- Option1: Do nothing. Government does not clarify existing powers.
- Option 2: Clarify existing powers to make specified activities licensable to make them expressly clear that they cover the activities of third party intermediaries, so that Ofgem is able to move quickly should its review conclude that there is a case to regulate their activities to ensure consumers are adequately protected.

Our preferred option is option 2, as it ensures that Ofgem can take action, if necessary.

**Will the policy be reviewed?** It will be reviewed. **If applicable, set review date:** 2018/19

| | | | | | |
|---|---|---|---|---|---|
| Does implementation go beyond minimum EU requirements? | | | **N/A** | | |
| Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base. | **Micro** Yes | **< 20** Yes | **Small** Yes | **Medium** Yes | **Large** Yes |
| What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent) | | | **Traded:** N/A | **Non-traded:** N/A | |

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister: Edward Davey Date: 08 May 2013

# Summary: Analysis & Evidence

Policy Option 2

**Description: Clarify existing powers to make specified activities licensable to make them expressly clear that they cover the activities of third party intermediaries, so that Ofgem is able to move quickly should its review conclude that there is a case to regulate their activities to ensure consumers are adequately protected.**

**FULL ECONOMIC ASSESSMENT**

| Price Base Year 2012 | PV Base Year 2013 | Time Period Years 7 | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | Low: 0 | High: 0 | Best Estimate: 0 |

| COSTS (£m) | Total Transition (Constant Price) | Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---|---|---|---|---|
| Low | 0 | | 0 | **0** |
| High | 0 | | 0 | **0** |
| Best Estimate | 0 | | 0 | **0** |

**Description and scale of key monetised costs by 'main affected groups'**

The estimated government staff and consultancy costs could be around £0.1m from secondary legislation if Ofgem deems there is a further need for regulation and applies for the activities of TPIs to become licensable, this could occur whether or not Government clarifies these powers. This is not a direct cost of clarifying powers as they may not be taken forward and therefore this is not included in the table above.

**Other key non-monetised costs by 'main affected groups'**

In the scenario where existing powers to make specified activities licensable do not cover the activities of TPIs there could be some potential costs to business from making clear that the powers do cover TPIs. This would be from bringing forward any costs that result from any regulation Ofgem may deem necessary (see scenario analysis in paragraphs 29-31). However, if in fact the activities of TPIs are already covered by the powers, there are no additional costs to business from this clarification. It is not possible to estimate what these costs would be as this would depend on the regulation that Ofgem deems necessary. Should Ofgem request a license from DECC then an IA will be developed on the basis of the request, setting out the costs and benefits to business and consumers.

| BENEFITS (£m) | Total Transition (Constant Price) | Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---|---|---|---|---|
| Low | 0 | | 0 | **0** |
| High | 0 | | 0 | **0** |
| Best Estimate | 0 | | 0 | **0** |

**Description and scale of key monetised benefits by 'main affected groups'**

N/A

**Other key non-monetised benefits by 'main affected groups'**

Clarifying that Ofgem can apply to the Secretary of State to licence TPIs' activities will ensure that Ofgem can act without unnecessary delay should its review conclude that a more regulatory approach is necessary to protect consumers. In the scenario where TPI activity is not within the scope of current powers to make a specified activity licensable there could be some potential benefits for consumers and business from clarifying that the powers do cover this by bringing forwards any benefits that result from any regulation Ofgem may deem necessary (see scenario analysis in paragraphs 29-31). However, if in fact TPIs are already covered by Ofgem's remit, clarifying powers could either result in no additional benefits to consumers and business, or small benefits from saving time as it would be clear there would be no grounds for appeal. It is not possible to estimate what these benefits would be as this would depend on the regulation that Ofgem takes forwards if it deems it necessary. Should Ofgem and DECC proceed with making TPI activity licensable then an IA will be developed on the basis of the request, setting out the costs and benefits to business and consumers.

In addition, if Ofgem decided to take a voluntary approach to ensure that TPIs are providing effective and impartial services, TPIs are more likely to work constructively with Ofgem if they know that Ofgem has the power to apply to licence them. Direct benefits of specific interventions will be considered at the secondary legislation stage.

| Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5 |
|---|---|---|

Ofgem's review of the regulatory framework for TPIs is carried out in the near future, is robust and accurately considers all evidence and impacts of any proposals appropriately.

**BUSINESS ASSESSMENT (Option 2)**

| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
|---|---|---|---|---|
| **Costs: 0** | **0** | **Net: 0** | No | Zero Net Cost |

# Evidence Base

### Background

1. In the broadest sense, Third Party Intermediaries (TPIs) are entities who intermediate between customers (both domestic and non-domestic) and suppliers. They may have a contractual relationship with one or both of the parties. Many suppliers contract with new customers primarily through TPIs. The importance of TPIs as an interface between consumers and the energy companies is also expected to grow, for example, with the introduction of smart meters and grids and an increased focus on energy efficiency.

2. TPIs in the non-domestic sector are energy brokers or agents who facilitate energy deals between businesses and energy suppliers, typically accessing a range of different supplier offerings. Their services can range from a one-off across the market comparison of offers to help a business switch to a new deal, to longer term relationships with a business such as account management, bill validation, and energy management services. They may also offer similar services in other utilities. A significant number of businesses use TPIs in the non-domestic market, particularly medium and large businesses. Datamonitor's B2B Energy Buyer Research indicates that 39 per cent of Major Energy Users (spending £50,000 per year on energy) used TPIs in the first half of 2012[1].

3. Currently Ofgem has no power to directly regulate TPIs that operate in the non-domestic sector. Ofgem is consulting on proposals to develop options for a common Code of Practice for non-domestic TPIs and is exploring the status of the code, the framework in which it would sit, and who would be responsible for monitoring the Code. In order to make the code binding on TPIs Ofgem could amend suppliers' licences to require them to contract only with those that have signed up to the code.

4. In the domestic sector, independent domestic price comparison sites are used by thousands of households every month and are now the main source of information for customers to compare tariffs across the market. Ofgem's Tracker Survey found that 34% of people who switched gas supplier found out about the deal on offer by using a comparison service, and 31% for electricity[2].

5. For the domestic sector, a voluntary code of practice for online domestic price comparison services already exists - The Confidence Code. Stewardship of this code past fromConsumer Focus, to Ofgem in spring this year. Ofgem plan to review the code now that they have responsibility for its administration.

6. In addition to reviewing the Confidence Code and consulting on a code of practice for non-domestic TPIs, Ofgem is also launching a parallel piece of work to review the regulatory framework for TPIs more generally. This work will consider the wider TPI-energy market issues, including areas where TPIs are taking or seeking to take active roles in the domestic sector as well as the work on the non-domestic sector.

7. Currently Ofgem may apply to the Secretary of State to licence activities that are "connected with" either the "supply of electricity" or the "supply to premises of gas conveyed through pipes". There is uncertainty whether the activities of TPIs would meet these definitions.

### Problem under consideration

8. Third Party Intermediaries are playing an increasing role in the energy market, both in the domestic sector and the non-domestic sector. Switching sites are now the main source of information for domestic consumers to compare tariffs across the market[3]. In Chapter 5 of their latest set of non-domestic RMR proposals, Ofgem have identified TPIs as likely to play an even bigger role in future with developments such as collective switching and smart meters taking place.

---

[1] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=298&refer=Markets/RetMkts/rmr
[2] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Customer%20Engagement%20with%20the%20Energy%20Market%20-%20Tracking%20Survey%202012.pdf
[3] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Customer%20Engagement%20with%20the%20Energy%20Market%20-%20Tracking%20Survey%202012.pdf

9. TPIs play an important role in creating active consumers by breaking down information barriers (see Annex A for details of the impact of consumer disengagement on competition and barriers to effective engagement, and Annex B for a summary of Ofgem's evidence and analysis from the Retail Market Review (RMR)). Trust in TPIs is therefore important for effective competition.

10. TPIs can offer invaluable support to consumers who are either time constrained, unsure of how to navigate the market to get the best deal for them, or both. Consumers should be able to trust their advice and, where problems are identified, should have an easily identified and accessible route to resolve them.

11. However, Ofgem have received complaints of some TPIs in the non-domestic sector who have misled consumers, or have not given them clear enough information. There is also frustration (from customers, suppliers and TPIs) that there is not a clear and reliable process to prevent further problems from occurring, or to identify TPIs that are delivering a poor service. If trust in TPIs continues to decline, resulting in fewer customers using their services, this could impact on the strength of competition in this part of the market.

12. Ofgem is planning to review the regulatory framework governing TPIs across both the domestic and non-domestic markets and will consider whether additional protection is required to ensure that consumers receive impartial reliable and clear advice when seeking to switch tariffs and/or supplier (or other energy related advice). In the first half of this year, Ofgem will publish an issues paper on the regulatory framework for TPIs. They will use this publication to help assess whether the current regulatory framework remains fit-for-purpose given the various and evolving roles and activities of TPIs.

13. If Ofgem's review concludes that additional regulation is necessary then the process under current legislation for introducing a licensing regime for TPI is as follows:
    - Ofgem consults on a proposal to apply for an activity to become licensable (along with the proposed standard licence conditions for the activity).
    - If any person which carries on the activity (or intends to do so) objects to the application, Ofgem is required to refer the matter to the Competition Commission (in which case, Ofgem may only proceed with an application if the Competition Commission decides that the fact that the activities in question are not licensable operates, or may be expected to operate, against the public interest).
    - Ofgem applies to the Secretary of State to make TPI activities licensable.
    - The Secretary of State consults on whether to proceed with making the TPI activity licensable (this can only be done at the instigation of Ofgem).
    - Government brings forward an order (statutory instrument) which creates the new licensable activity. This would have to be debated and agreed by both Houses of Parliament.
    - Ofgem can then introduce licence conditions on TPIs.

14. There is currently some uncertainty over whether or not the power to licence new activities would cover brokering energy supply, tariff comparison entities and other TPI activity.

15. Given ambiguity surrounding the scope of the powers, it is possible that an objection could be raised on these grounds and therefore trigger a reference to the Competition Commission. In addition, a challenge by way of judicial review could potentially be brought on the basis that Ofgem's application or the use of the Secretary of State's order making powers are ultra vires. Both situations would lead to delay and could potentially prevent the introduction of a licence regime for TPIs which Ofgem had concluded would lead to better outcomes for consumers.

**Rationale for intervention**

16. Both business consumers and domestic consumers are increasingly turning to TPIs to help them identify the best deals so it is vital that they have confidence that the service the TPI provides is impartial and that the information provided is accurate.

17. Ofgem's forthcoming review will consider whether there is a problem of poor or unreliable service by TPIs, which would be likely to fuel further consumer disengagement from the market, resulting in reduced competitive pressure on suppliers. If they identify any such problems they will bring forward proposals to mitigate these, which could be either voluntary or regulatory. Ofgem will need to ensure that the benefits outweigh the costs in designing any proposals.

18. If clarifying the powers were delayed until the outcome of the forthcoming review, an appropriate primary legislative vehicle may not be readily available, which could lead to a delay in the licensing of TPIs. This would not allow problems that are identified by Ofgem in its review to be resolved in a timely manner.

19. Government intervention is needed to clarify that powers to make specific new licensable activities extends to activities undertaken by TPIs. It is important that Ofgem is able to act without undue delay to protect consumers if its review concludes that there is a case for further regulation.

**Policy objective**

20. The policy objective is to ensure that Ofgem has the necessary powers to regulate TPIs so that consumers are confident that the service they provide is impartial and the information they impart is accurate. Consumers need to be confident that TPIs are acting in their best interests.

21. This impact assessment examines the costs and benefits of the clarification of the primary powers. The impact of any specific interventions, if Ofgem requests them, would be examined separately, alongside any consultation on secondary legislation, with a full impact assessment.

**Description of options considered:**

22. We have considered the following options:

- Option 1: "Do nothing". Government does not clarify existing powers.
- Option 2: Clarify existing powers to make specified activities licensable to make them expressly clear that they cover the activities of third party intermediaries, so that Ofgem is able to move quickly should its review conclude that there is a case to regulate their activities to ensure consumers are adequately protected.

**Option 1**

23. If the Government did not act, there would be no certainty around Ofgem's ability to apply to the Secretary of State to make an order which introduces a licence regime which covers the activities of TPIs. Ofgem could still apply to the Secretary of State, but given the ambiguity surrounding the scope of the powers, an objection could be raised which could trigger a reference to the Competition Commission resulting in the regulation being delayed. If the appeal was successful Government would then have to amend the powers through primary legislation to enable Ofgem to regulate TPIs. This would further delay or prevent the introduction of a licence regime for TPIs which Ofgem had concluded would lead to better outcomes for consumers.

24. Ofgem could still improve the Confidence Code for price comparison sites and could introduce a code of practice for TPIs in the non domestic sector. It could not, however, make either of these codes binding on TPIs and would have to rely on TPIs voluntarily signing up to the standards in the code. Ofgem would have the option of requiring suppliers to deal with only those TPIs that signed up to the codes. However, this puts the onus on suppliers rather than TPIs. Ofgem would not be able to take direct enforcement action against TPIs for breaches of voluntary codes.

**Option 2**

25. Our preferred option is to clarify Ofgem's powers to make clear that it can apply to the Secretary of State to licence the activities of TPIs. This will ensure that Ofgem can move quickly to regulate TPIs should its review conclude that further regulation is necessary to protect consumers, without the risk of an appeal on the grounds that current powers to not cover TPIs. Licensing TPIs would allow Ofgem to place binding conditions on TPIs to ensure that they treat consumers fairly and do not mislead them.

26. If clarifying the powers were delayed until the outcome of the forthcoming review, an appropriate primary legislative vehicle may not be readily available, which could lead to a delay in the licensing of TPIs, see scenario analysis below. This would not allow problems that are identified by Ofgem in its review to be resolved in a timely manner. This would result in any potential harm on consumers continuing unnecessarily and risking further distrust in the sector.

27. If Ofgem decide to use a voluntary approach following the forthcoming review it is likely to be more effective as it will be clear that a licensing regime could be introduced to back up the approach.

28. The estimated government staff and consultancy costs could be around £0.1m from secondary legislation if Ofgem deems there is a further need for regulation and applies for TPI activity to become licensable this could occur whether or not Government clarifies these powers. This is not a direct cost of clarifying powers as they may not be taken forward and therefore this is not included in the cost benefit analysis and summary tables on page 2.

***Scenario Analysis***

29. In considering the impacts of the options presented here a scenario analysis was taken forwards, as presented below. In summary, clarifying powers insures against the risk that the net welfare gains of any regulation Ofgem deems necessary could be delayed by an appeal on the basis that Ofgem's powers do not allow it to apply to licence TPIs. Also amending powers brings certainty for all, which has related benefits if Ofgem deems it necessary to regulate, but also potential benefits of a more constructive approach from TPIs to voluntary agreements as it is clear that if that a voluntary approach is not successful, then Ofgem has the power to regulate.

30. Should Ofgem decide regulation is necessary there are a range of possible scenarios:

- If in fact, TPI activities are covered by the present powers then:
  - (a) In the do-nothing option, the regulation could be implemented in a timely manner if no appeal is brought forward. Alternatively if there is an appeal it would be rejected leading to a short delay to the implementation of Ofgem's proposed regulations.
  - (b) In option 2 where the powers are amended to be clearer about potential licensable activity, hence removing the grounds for appeal, the regulations are set in a timely manner. There is, therefore, only a small difference between the do-nothing and option 2 in terms of delivering the benefits of Ofgem's proposed regulations.
- However, if TPI activities are not covered by the present powers then:
  - (c) In the do-nothing option, there could still be no appeal allowing the regulation to be set in a timely manner, but there is an increased probability of a successful appeal. This would lead to a delay in the regulations by the time it takes for the Competition Commission to review the case, and then the time taken to amend the powers.
  - (d) In option 2, it is clear that there is no ground for appeal on the basis that TPIs are not covered in Ofgem's remit, and regulation is implemented in a timely manner. The impact of clarifying the powers now is to insure against a scenario where the benefits identified by Ofgem from regulation are delayed significantly. These would include consumer protection and could increase consumer engagement through potentially improved trust in TPIs. This would also mean that the costs of regulation on businesses in the sector would occur earlier than they would do in the do-nothing scenario.

31. Should Ofgem decide regulation is not necessary the following 2 scenarios are possible:

- Do nothing, Ofgem does not act following review, or pursues voluntary measures for TPIs;
- Amend powers, powers are not exercised, but in light of the certainty that TPIs are covered in Ofgem's remit, there could potentially be more constructive joined up work by the sector if any voluntary agreements were taken forward.

32. Ofgem is planning to review the regulatory framework governing TPIs across both the domestic and non-domestic markets and will consider whether additional protection is required to ensure that consumers receive impartial and clear advice when seeking to switch tariffs and/or supplier. With this review Ofgem will collect together and consider evidence to see whether action is needed here. We are supporting Ofgem's review by clarifying this power and giving the market certainty that Ofgem

can apply to the Secretary of State if it deems it necessary. Therefore an analysis of the impacts of introducing a licensing regime for TPIs is not needed at this stage.

**Risks and assumptions**

33. Ofgem's review of the regulatory framework for TPIs is carried out in the near future, is robust and accurately considers all evidence and impacts of any proposals appropriately.

**Direct costs and benefits to business calculations (following OIOO methodology);**

34. In the scenario where TPI activity is not included in the activities which can be made licensable in at present there could be some potential costs to business from clarifying the powers to make clear that Ofgem can apply to the Secretary of State to licence the activities of TPIs, from bringing forward any costs that result from any regulation Ofgem may deem necessary (see scenario analysis in paragraphs 29-31). However, if in fact TPIs are already covered by Ofgem's remit, there are no additional costs to business from clarifying powers. It is not possible to estimate what these costs would be as this would depend on the regulation that Ofgem takes forwards if it deems it necessary.

35. Any further impact assessment that is required during this process will be undertaken in accordance with the regulatory requirement. A full impact assessment would be published alongside the secondary legislation which creates the new licensable activity, should Ofgem request it. At that time Government would consider all available views and evidence, and carry out further analysis if necessary.

**Wider impacts**

36. There are no wider impacts from clarifying Ofgem's powers to make clear that it can apply to the Secretary of State to licence the activities of TPIs.

**Specific impact tests**

Competition impacts

37. Primary legislation is not expected to have significant direct impacts on competition. The potential impact on competition will be considered in more detail if secondary legislation is introduced.

Small and micro business impacts

38. Primary legislation is not expected to have significant direct impacts on small or micro businesses. The potential impact on small and micro businesses will be considered in more detail if secondary legislation is introduced.

Equalities

39. Primary legislation is not expected to have any differential impacts on the basis of the protected characteristics. We will consider equality impacts in more detail, if the Secretary of State decides to use primary powers.

Human Rights

40. To the extent that human rights may be engaged, we consider the approach to be compatible with the Human Rights Act 1998.

Other specific impacts

41. Primary legislation is not expected to have any differential impacts in the following areas: wider environmental impacts; greenhouse gas impacts; health impacts; justice impacts; rural proofing impacts; and, sustainable development impacts.

**Post-implementation Review**

42. The Secretary of State would examine the impacts of any license request from Ofgem. We envisage that monitoring and enforcement of any intervention would be the role of Ofgem, and that further details of the monitoring and evaluation process would be made available at a more advanced stage of policy development.

**Summary and preferred option with description of implementation plan.**

43. Our preferred option is to clarify existing powers to make clear that Ofgem can apply to the Secretary of State to licence the activities of TPIs. This will ensure that Ofgem can move quickly to regulate TPIs should its review conclude that further regulation is necessary to protect consumers. Licensing TPIs would allow Ofgem to place binding conditions on TPIs to ensure that they treat consumers fairly and do not mislead them.

## Annex A

**Further detail on the impact of consumer disengagement and barriers to effective engagement problem – as presented in the Impact Assessment for Consumer Tariff Amendments (power a-e) – Ofgem RMR related powers**

44. In a perfectly competitive market both consumers and suppliers have full information on anything that might influence their respective decision-making processes, for example supplier costs, alternative products and prices. However where a party has incomplete information, they are at a disadvantage in the market. At present, suppliers are better informed than individual consumers, particularly domestic consumers, leaving them at a competitive disadvantage[4].

45. The fact that the majority of customers do not shop around to seek out the best deals and that suppliers can differentiate their offers between new and existing customers means there is less pressure on suppliers to compete (see Box 1) than in a perfectly competitive market. Suppliers currently compete only for the minority of customers that shop around, making market entry by new suppliers difficult. This potentially results in higher prices for the majority of consumers that do not engage, some of which remain on poor value "dead" tariffs.

**Box 1: Impact of consumer disengagement on competition**

Consumers play a key role in a well functioning market. Through their active participation and choices in the market, consumers put pressure on suppliers to offer the products that consumers want at competitive prices. However, 'sticky' customers can create for suppliers a degree of slack, and reduce the incentive to drive down costs and to innovate to meet consumers' preferences, and potentially leading to higher prices for consumers. In order to be active, consumers need to have a clear understanding of how to access, assess and act on market information to choose the best product and tariff.

When suppliers make excess profits or act inefficiently, this should incentivise new entrants into a market. However, consumer disengagement puts new entrants to the retail market at a potential disadvantage. Any new entrant has to offer larger discounts to incentivise consumers to switch compared to a more competitive market. New entrants have no sticky customers that were inherited at the time of market opening as the incumbents do, they have had to compete to gain all their customers and so all their customers are [or at least were at one point] active in the market. The customers of new entrants are more likely to switch than those of incumbents, and therefore new entrants cannot segment their customers in the way incumbent suppliers can.

This market structure enables the incumbents to offer more competitive tariffs to those who do switch whilst keeping the tariffs of sticky customers higher (see Annex B paragraph 49). The fact the large incumbent suppliers are able to undercut new entrants due to their more profitable large 'sticky' customer base makes new entrance difficult. This increases the incumbents' market power and leads to potentially higher prices.

46. The reasons for this lack of engagement (see Box 2) include the proliferation of tariffs and complex tariff structures which make it difficult for consumers to compare tariffs and understand which offer the best value for them and the lack of clear information on bills. Another factor is a lack of awareness that cheaper tariffs exist[5]. Many consumers are not confident enough to engage in the market and/or are put off by the perceived hassle and time it takes to switch supplier. Others may be aware that there are savings to be made but in the absence of a specific prompt or trigger to act, stick with the tariff they are already on[6].

[4] Ofgem's Retail Market Review – Impact Assessment for the final domestic proposals, http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/The%20Retail%20Market%20Review%20-%20Final%20Impact%20Assessment%20for%20domesitc%20proposals.pdf
[5] SPA Future Thinking, 'Options for cheapest tariff messaging on customer communications; Report of qualitative research', 2012
[6] SPA Future Thinking, 'Options for cheapest tariff messaging on customer communications; Report of qualitative research', 2012

**Box 2: Barriers to effective consumer engagement**

Ofgem has carried out consumer research and analysis to assess the barriers to consumer engagement which they have presented in the recent RMR document[7]. The barriers to engagement that Ofgem identified are:

● Complex tariffs – the number of different tariff structures on offer are confusing, with complex structures, including multi-tier tariffs and various discounts applied. This puts off many consumers from searching, leads some consumers to abandon their search, may result in an increased frequency of poor switching decision and contributes to a lack of trust in the industry.

● Inadequate information – there is evidence to suggest that consumers find information that they are sent from suppliers difficult to understand and use, particularly for vulnerable customers.

● Lack of trust and poor supplier conduct – there is evidence that the overall perception of the energy industry is fairly negative, and suggests that consumers believe suppliers make it deliberately difficult to switch supplier.

Behavioural economics also suggests that consumers have:

● Limited capacity to assess complex information, or 'bounded rationality', when making decisions on switching. Time and attention are a scarce resource for an individual and so use rules of thumb when the information they need to assess is complex; this often results in non-optimal decisions.

● 'Status quo bias' – consumers have a tendency to not change from what they are currently doing unless they face strong reasons to do so.

● Loss aversion – consumers feel more strongly about losing rather than gaining value, and therefore could be less likely to switch for fear they may be worse off.

● High discount rate – consumers put more weight on the costs/hassle of switching than the gains they could achieve over a longer time period by switching.

Source:
-'What can behavioural economics say about GB energy consumers?' Ofgem March 2011
http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Behavioural_Economics_GBenergy.pdf
-'Assessing the effectiveness of potential remedies in consumer markets' OFT April 2008,
http://oft.gov.uk/shared_oft/economic_research/oft994.pdf

47. The evidence provided by Ofgem in the Retail Market Review is clear that the majority of consumers do not engage in the energy market and are paying more than they would be if they were on a lower available tariff.

[7] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/The%20Retail%20Market%20Review%20-%20Final%20domestic%20proposals.pdf

**Annex B: Summary of Evidence and Analysis from Ofgem**

Competition Analysis

1. Ofgem presents evidence on the current state of competition in the domestic electricity and gas retail market alongside their updated proposals. This is briefly summarised below; further detail can be found in the Retail Market Review[8].

*Switching Suppliers, Tariffs and payment methods*

2. "Sticky" customers (indicated by low levels of switching) make it difficult for new entrants to attract a customer base. Ofgem's tracker survey shows just 13% of gas customers and 14% of electricity customers switched their supplier in 2011, which is a decline below the level of 2010. This is a third year of decline for gas customers and a fourth year of decline for electricity customers[9]. In addition, among those who did not switch supplier in 2011, only 12% of both gas and electricity customers switched their tariff or payment method between January 2011 and March 2012 (when the survey was conducted). Almost two thirds of consumers claim to have never switched energy supplier. This is likely to be an underestimate but reflects the perceptions of consumers that they are inactive in this market. The Quarterly Energy Prices[10] publication by DECC shows that in December 2012, 38% of electricity customers were still with their home supplier, whilst 41% of gas customers were[11].

*Market share and market power*

3. The combined share of the six largest energy suppliers account for more than 98% of the domestic energy market. Due to the transition from monopoly provision, each of the major suppliers have an incumbent or legacy customer base – British Gas was the supplier of gas for all customers in GB and the other large suppliers all have legacy electricity customers in the regions where they were the sole supplier. There are around nine small suppliers who make up the rest of the market.

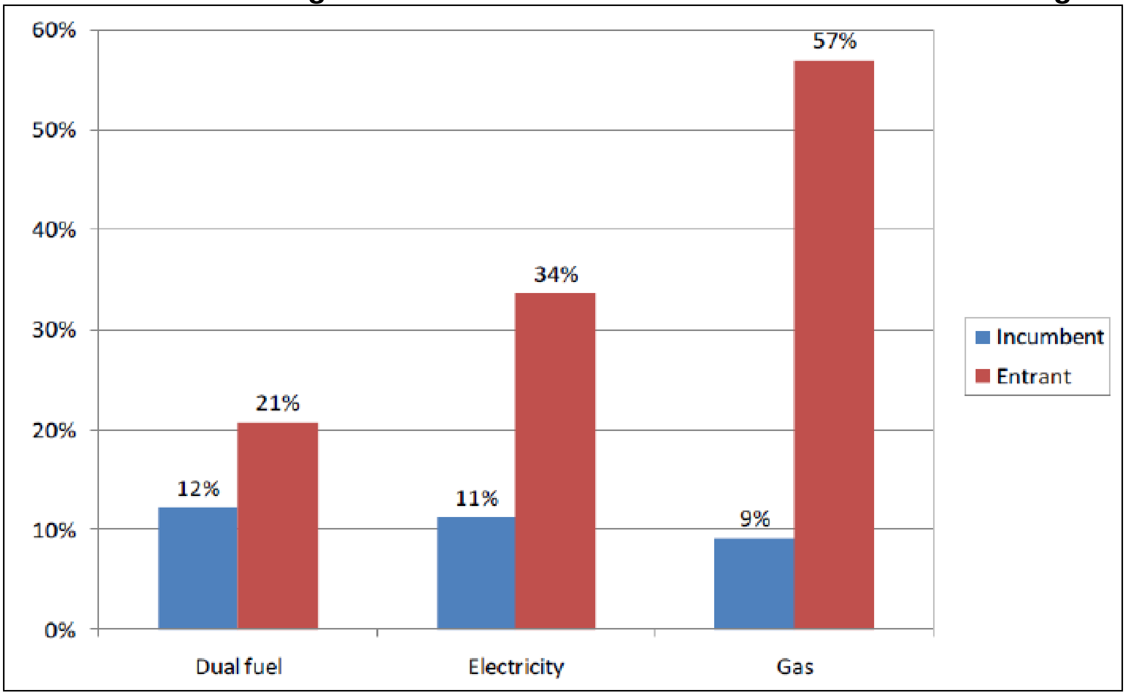
4. Ofgem use the OFT market concentration measures, which show that the single-fuel gas market is highly concentrated and the duel-fuel and single-fuel electricity are concentrated.

*Churn: suppliers and customer types*

5. Incumbents can segment the market between their less active legacy customer and their more active new customers. Ofgem state that electricity customers of new entrant suppliers switch at three times the rate of the incumbents' customers and gas customers of new entrant suppliers switch over six times the rate of the incumbent's customers, see Figure 2 below.

[8] The Retail Market Review – Final domestic proposals, April 2013 and Updated domestic proposals, October 2012 available here: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=460&refer=Markets/RetMkts/rmr and http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=300&refer=Markets/RetMkts/rmr
[9] Ofgem highlight that the main reason for this could the voluntary cessation of doorstep selling from suppliers.
[10] https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-price-stastics
[11] However, of those with the home supplier, some could have switched away and switched back again.

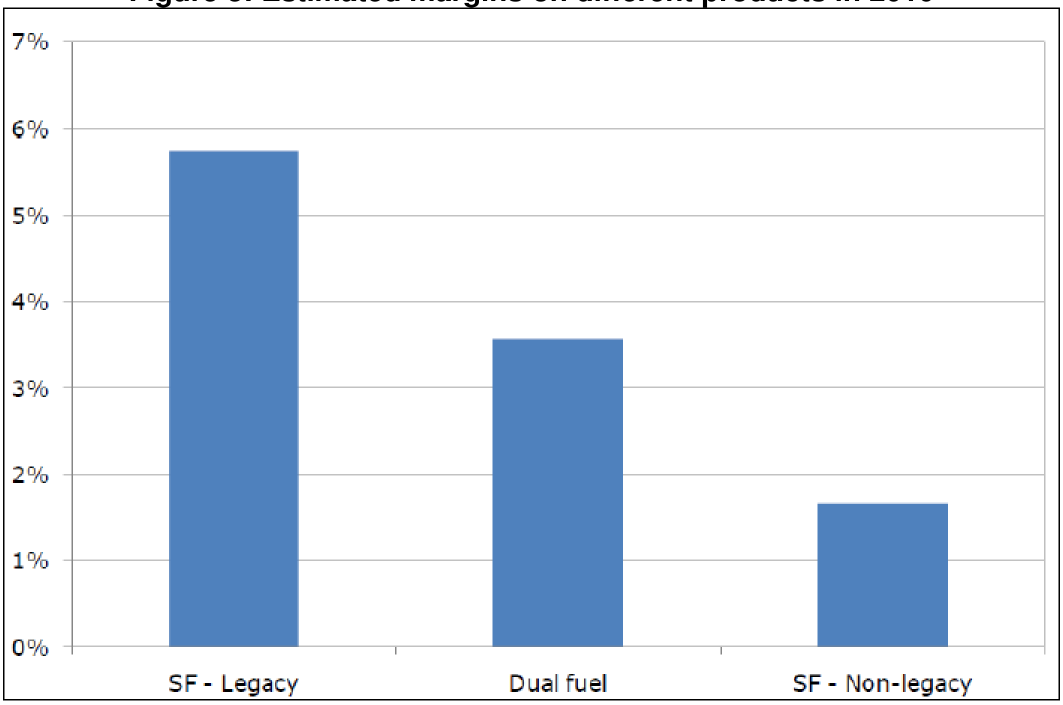
**Figure 2: Annual churn of region incumbents and entrants between March and August 2010**[12]




*Margins: incumbent suppliers and their customers*

6. The six largest suppliers make a higher margin on the fuel that they are an incumbent for – which suggests they have a degree of market power because these consumers are less likely to switch to a new supplier. The estimated margin earned in 2010 from single fuel (SF) legacy customers[13] is more than 5% which is significantly higher than duel fuel customers (less than 4%) or single fuel non legacy customers (less than 3%), see Figure 3 below. This in turn partly reflects the impact of selective online discounts, which reduce the margin earned from some active customers. In addition, the Energy Supply Probe in 2008 found that historically the major suppliers charged higher prices to customers in the region they were the incumbent supplier for than customers from other regions.

**Figure 3: Estimated margins on different products in 2010**




[12] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/The%20Retail%20Market%20Review%20-%20Updated%20domestic%20proposals.pdf
[13] British Gas in the case of gas and the remainder of the incumbent suppliers in the case of electricity.

*Vulnerable consumers and switching*

7. Ofgem's tracker survey suggests that consumers who could be vulnerable are more likely to say they have never switched. Non-switchers are more likely to lack internet access, belong to the least affluent social groups (DE), live in rented accommodation and live in rural areas, be from black & minority ethnic backgrounds and pay their bills by standard credit or pre-payment meter. This indicates that more vulnerable consumers are still with their incumbent supplier and therefore are likely to be in the group that suppliers charge higher prices to and make a higher margin from.

Consumer Research in Ofgem's Retail Market Review

8. Ofgem commissioned various new consumer research reports as part of the RMR process which used a variety of qualitative research methods, including individual and group interviews and larger workshops. Together these provide useful insights into how to encourage effective engagement in the energy market. Some of the main findings of the reports are summarised below; more detail on the research can be found in Appendix 6 of the October 2012 RMR consultation[14] and the specific reports can be found on the RMR website.

   - Many consumers find choosing a tariff difficult, time consuming and complicated and some feel that the savings may not make the effort worthwhile. Findings from the March 2012 Consumer First Panel[15] show that confusion about what was on offer was a significant barrier for consumer engagement. Many panellists found the choice between so many options the source of their confusion and some panellists believed tariff proliferation proved suppliers are not acting to help consumers. In addition, the complexity of tariffs added to confusion and therefore disengagement, with the lack of standardisation found to discourage cross market comparisons.
   - Overall, participants found comparison guides could be used to help choose the cheapest tariff for them. However, the research did not find any format that performed substantially better than the others.
   - The majority of participants thought that a tariff comparison rate could make it easier to pick the best tariff for them.
   - Participants preferred communication that was short, using simple language and personalised to them. Only key information such as amount to pay would be read.
   - Participants generally preferred information on both the cheapest tariff for their current payment method and the cheapest tariff overall to be included.

[14] See Appendix 6 - Recent Consumer Research in the RMR Supplementary Appendix document available here: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=300&refer=Markets/RetMkts/rmr

[15] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Consumer%20engagement%20with%20the%20energy%20market,%20information%20needs%20and%20perceptions%20of%20Ofgem.pdf