Department for
Business, Energy
& Industrial Strategy

Tackling the loyalty penalty in the retail energy market

Analytical Annex

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Contents

About this document

1. This annex sits alongside the BEIS 2021 Energy Retail Market Strategy, Price Cap announcement and consultation on opt-in and testing opt-out switching.[1] It summarises the evidence base that underpins the rationale for change; the main objectives behind the policy strategy; the combinations of options being considered; and provides a high-level discussion of the expected impacts of the options.

2. As the proposals for the scope and specific designs of opt-in and testing opt-out switching ('the switching schemes') are currently in development and will be informed by the responses to our consultation, we have not undertaken an impact assessment of individual measures at this stage. However, corresponding impact assessments will accompany any subsequent legislation.

Background and policy context

3. This section summarises the current residential energy retail market context, including existing policy to tackle the issues caused by a lack of effective competition in the default tariff market. It also outlines the government's announcements in the Energy White Paper to introduce opt-in switching and opt-out trials as methods to improve effective competition in the domestic market.

The government and regulator took decisive action to tackle the longstanding loyalty penalty and its inequitable outcome for vulnerable consumers following the CMA's 2016 investigation

4. Since the privatisation of the energy retail market two decades ago, the level of competition has improved significantly. However, this increase in competition has not brought benefits to all consumers, including many of the most vulnerable. Customers who do not engage with the market, for example through switching, remain or are rolled onto their supplier's 'default tariff'. Since these consumers are defined by lower levels of engagement, suppliers are given a position of unilateral market power over them, which weakens competition for their custom and means they are consistently charged higher prices. An assessment of this was formalised by the CMA in their 2016 Energy Market Investigation.[2]

5. This has since become referred to as the 'loyalty penalty' and is a feature common to many similarly structured markets. In the energy market, it affects a large proportion of

[1] https://www.gov.uk/government/consultations/energy-retail-opt-in-and-testing-opt-out-switching https://www.gov.uk/government/publications/energy-retail-market-strategy-for-the-2020s
[2] https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

households, and is more likely to affect those in a variety of vulnerable situations. In 2018, the CMA identified loyalty penalties occurring in five further retail markets: mobile, broadband, cash savings, home insurance, and mortgages. They also analysed the causes of loyalty penalties and offered recommendations for tackling them.

6. Following the CMA's Energy Market Investigation, Ofgem introduced a cap on prices paid by prepayment meter and some other vulnerable customers (the safeguard tariff). Following this, to ensure all vulnerable customers received protection from the loyalty penalty, the government introduced the market-wide Default Tariff Cap (the price cap) in 2019, which is administered by Ofgem. This market-wide price cap now also applies to almost all customers previously covered by Ofgem's safeguard tariff.

Price caps were introduced as temporary measures to allow for progress to be made in the development of effective competition

7. The government and Ofgem are in the process of introducing market reforms that will facilitate effective competition and support efforts to tackle the loyalty penalty. These include the introduction of Ofgem's Switching Programme; the smart meter rollout; Settlement Reform; and smart data initiatives such as the Midata programme.[3] These measures focus on tackling the technical barriers to engagement and facilitate competition by enabling consumers to make more informed decisions on their energy tariffs. This includes the smart meters rollout, which has reached around 40% coverage, and aims to reduce technical barriers by showing consumers both real-time and historic information on their energy use and its cost, making it easier to compare tariffs and ensure they are paying a competitive price for their energy.

8. Building on these reforms, the government also set up the joint Future Energy Retail Market Review in March 2019 to consider what further enduring measures may be needed and consulted on possible policy, legal and regulatory changes in the energy retail market in July 2019.[4] This review laid the foundations for subsequent reforms, primarily set out in the 2020 Energy White Paper.

9. Each year since the introduction of the cap, Ofgem are required to undertake a review and make a recommendation to the BEIS Secretary of State, who determines whether the cap will be extended for a further year, based on whether the conditions for effective competition are present. Under current legislation, the Default Tariff cap cannot be extended beyond the end of 2023. To ensure that protection from a loyalty penalty can continue beyond 2023 should effective competition not be present, the government intends to seek legislation to enable potential extensions of the price cap beyond this date.

[3] Work on Midata has been paused for 2020/21, as Ofgem recognise that there are a number of programmes in train across the industry that will also impact industry data availability and quality. https://www.ofgem.gov.uk/publications-and-updates/update-midata-energy-programme
[4] https://www.gov.uk/government/consultations/flexible-and-responsive-energy-retail-markets

10. On 20 October 2020, the government announced that the price cap would be extended for another year, until the end of 2021 at the earliest.[5] There have been some improvements in the effectiveness of competition since the cap's introduction, such as increased engagement among some consumers, rising switching levels and progress with the smart meter rollout. However, despite this, there is still more to do to ensure consumers will not face unfair prices in its absence. If the price cap expires before the conditions for effective competition are in place, there is a substantial risk that the millions of consumers who remain on default tariffs will be exposed to the excessive charging that existed before the price cap's introduction.

The government will work with industry to continue to take bold steps to improve competition but will ensure there is no break in protection from excessive charging for those who need it

11. To address the loyalty penalty in the energy retail market by developing a more competitive market, the government announced in the 2020 Energy White Paper that it will:

- Create the framework to enable the incremental introduction of an opt-in switching scheme;
- Test opt-out switching as part of considering how default tariff arrangements might be reformed

12. These switching schemes seek to tackle the persistent underlying causes of the loyalty penalty. A first consultation on their implementation has been published alongside this document.

13. At the same time, the government has considered options for continuing protection for consumers after 2023, if conditions for effective competition are still not present. We have concluded that allowing the cap to remain in place beyond the end of 2023, if needed, is the best option while we continue to address the underlying factors that have caused a loyalty penalty.

Rationale for change

14. A variety of factors underpin the rationale for instilling change. Of particular relevance are the scale of the loyalty penalty and the characteristics of those who it affects; as well as the nature of the market failures that weaken the effectiveness of competition and enable the loyalty penalty to persist. The scope of these market failures goes beyond the technical barriers to consumer engagement, which are the focus of existing measures, such as the smart meter rollout and schemes like Midata, and includes

[5] https://www.gov.uk/government/news/11-million-households-to-make-savings-as-government-extends-cap-on-energy-bills

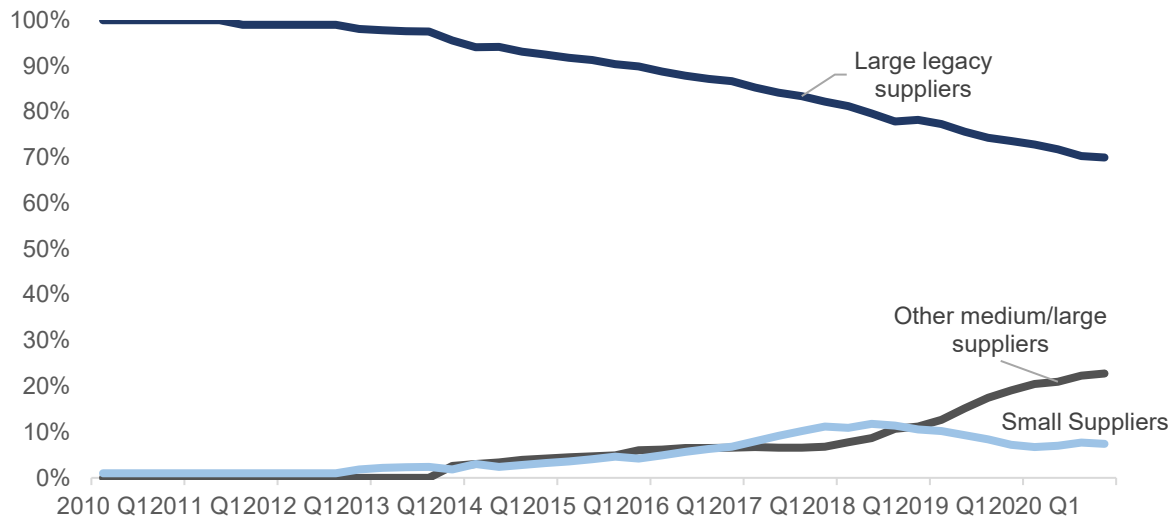
important underlying behavioural constraints, such as cognitive biases. These factors, and the role of policy change in helping to overcome them, are discussed below.

Although competition in the retail energy market has increased, many consumers have not benefitted

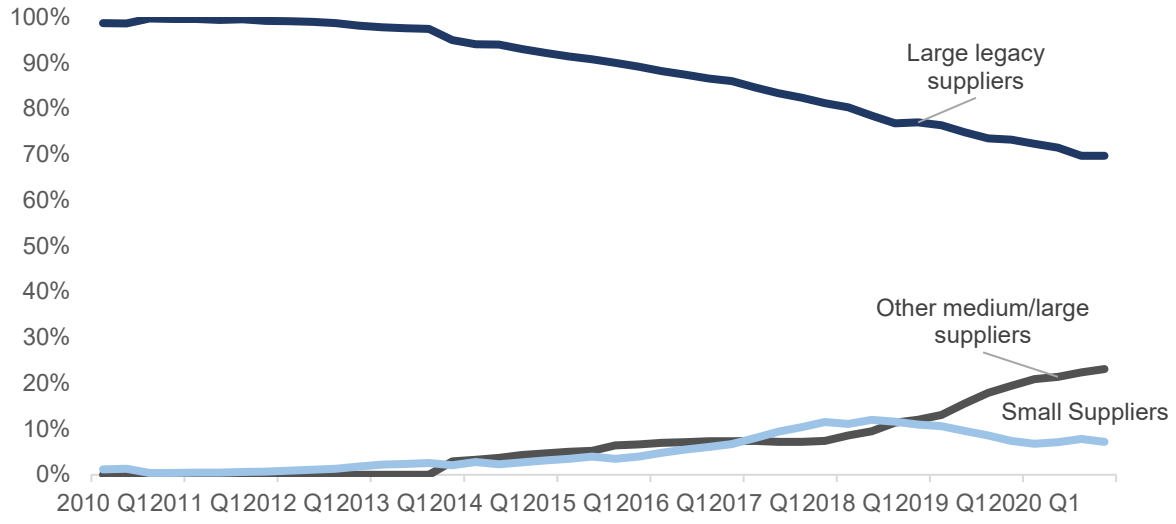
15. Since energy retail markets were privatised, there have been significant improvements in the level of competition. This has particularly been the case over the last decade, which has seen a large number of new firms enter the market, many of which have successfully grown their market share (see Figure 1). To a large extent, this has been facilitated by steadily increasing levels of consumer engagement and switching. These changes have meant engaged consumers have a wide range of tariffs to choose from, at competitive prices.

Figure 1: Market share of GB domestic suppliers by type since 2010 (Source: Ofgem retail market indicators)

a) electricity supplier



b) gas supplier



16. However, the energy retail market continues to operate with two broad tiers:

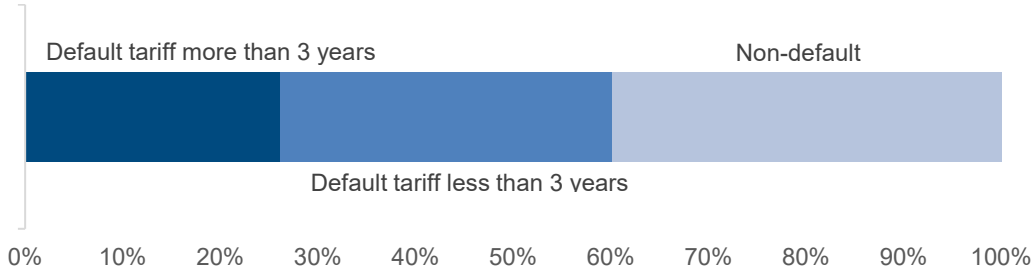
- A competitive tier, with suppliers competing to attract customers who engage with the market by switching tariffs or supplier. This competition is mainly driven by price, with some secondary features such as the environmental credentials of the tariff and customer service.[6] [7] This tier represents a segment of the residential energy market that has grown but is still less than half the market.
- A default tariff tier of customers who do not regularly engage with the market. While there is likely to be some movement into and out of this segment, it still typically comprises over half the market.

17. In the absence of intervention, this two-tier market enables suppliers to charge disengaged customers significantly more than the cost to serve them, with minimal risk of losing their custom. This enables suppliers to earn excess profits, or to persistently operate with significant inefficiencies. In 2016, the Competition and Markets Authority (CMA) calculated that this loyalty penalty was a significant cost for energy customers of the largest suppliers and estimates by Ofgem have found a similar scale of detriment of around £1.5bn per year. [8,9]

The loyalty penalty in energy negatively impacts a large group of customers who are disproportionately likely to be in vulnerable situations

18. The loyalty penalty in the default tariff market is persistent. Many customers on default tariffs consistently do not engage with the energy market, despite the money they could save. This is particularly the case for consumers who remain on default tariffs for a long time. [10] Ofgem's data from 2020 shows that 60% of customers are on default tariffs (see Figure 2) and that on average across 2020, during which the default tariff cap was in place, these customers could save £290 per year by switching to a fixed tariff deal. [11,12] Despite the savings possible, 35% of default tariff customers state they have never switched supplier.[13]

Figure 2: Proportions of domestic electricity customers on different tariff types, October 2020 (Source: Ofgem Supplier Request for Information)



[6] We use outputs from Ofgem's 2019 Consumer Survey to allow comparability with previous years, given changes to survey methodology in 2020, and the potential for one-off factors resulting from the effects of COVID 19.
[7] Ofgem, Consumer Survey 2019, Consumers Engagement Survey 2019 Data Tables, Table 170
[8] Ofgem (2018) Final Impact Assessment: Default Tariff Cap
[9] CMA (2016) Energy Market Investigation, Final Report,
[10] More evidence on this is provided under option 3.
[11] Ofgem, All supplier RFI data.
[12] Ofgem, Retail Market Indicators, updated regularly.
[13] Ofgem Consumer Engagement Survey, 2019.

19. It is also the case that consumers in vulnerable situations are less likely to engage with the market and are more likely to face a loyalty penalty as a result. Repeated Ofgem Consumer Surveys have found that those in lower social grades and with lower incomes are more likely to be disengaged. The most recent of these published surveys (2019) found that the proportion of households in the lowest social grades (DE) that report never having switched energy supplier was 43%, compared to 20% of consumers in the highest social grades (AB). Similarly, in 2016, the CMA found that customers with vulnerable characteristics were more likely to have never considered switching or shopping around within the previous three years.[14] These were households who may have incomes below £18,000 a year; live in private rental or social housing; have no qualifications; are disabled; or are on the Priority Services Register (PSR). In this sample, around 15-20% of those with vulnerable characteristics switched, compared with around 30-35% of those who were 35-44, held a degree, earned over £36,000 or had a mortgage.

20. Low income and other customers in vulnerable situations are also more likely to face disproportionate impacts from higher energy prices since energy costs often comprise a higher proportion of their income. They are also more likely to be exposed to the risks of under-consumption of energy, including to health, such as from the rationing of heat among those at risk of fuel poverty.

21. A form of loyalty penalty also extends to other sectors, such as mobile, broadband, cash savings, home insurance, and mortgages.[15] This may be because many of the market failures discussed below that give rise to loyalty penalties have particular relevance for many of those in vulnerable circumstances. As such, it is likely that many vulnerable customers may also be suffering from loyalty penalties in other areas of life, and cumulatively may incur significant additional costs.

Reduced consumer engagement has significant implications for competition between suppliers and resulting consumer outcomes

22. It is longstanding policy in the UK and other developed economies to harness competitive mechanisms to deliver better outcomes for consumers. In a market where the market failures discussed below mean that a large number, if not a majority, of customers remain on contracts they have not actively engaged with, and where a large minority have never actively engaged, there is a limited pathway through which competition can have its desired effects. In particular, limits are placed on the potential growth of the most efficient and highest quality suppliers, reducing the pressure this process can place on competitors to improve their prices and services offered.

23. Overcoming some of the behavioural barriers to consumer engagement may also be a prerequisite for achieving net zero in the most cost-effective manner. As the retail

[14] CMA, Energy Market Investigation: Final Report: Figure 9.1
[15] CMA, Tackling the Loyalty Penalty (2018). https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/892058/Loyalty_Penalty.pdf

energy market evolves, and consumers have more choice of tariffs and other products enabled by the transition to a smarter, net zero consistent energy market, we expect engagement to become more important.

The loyalty penalty is a symptom of a range of market failures, which mean that a large portion of the market is not characterised by effective competition

24. In their 2018 response to the Loyalty Penalty Super Complaint, the CMA identified the causes of the loyalty penalty in consumer markets.[16] Many are highly relevant to the domestic retail energy market:

- **Automatically renewed and deemed contracts.** Due to the importance of the continuity of supply to customers, the energy market regulatory framework allows 'default arrangements' to be applied. These take the form of automatically-renewed contracts for customers outside of fixed-term contracts and deemed tariffs for those new to a property. As highlighted by the CMA, such arrangements directly contribute to loyalty penalties in a variety of consumer markets, since they enable consumers to remain 'passively loyal' with their existing supplier. This creates a market segment particularly at risk of weak competition, because of the almost by definition reduced extent of market engagement by consumers on default tariffs, and the ease with which they can be identified by suppliers.
- **Barriers to market information and engagement.** Consumers rely on access to high-quality information and advice on factors such as price and customer service to make informed choices. This is particularly important in a competitive market, with a wide variety of suppliers and variation in the types of tariffs available, depending on consumer usage patterns and preferences. Several information barriers are likely to restrict customers from understanding the market:
    - **Perceptions that shopping around can be very time and cognitively consuming.** Engaging with the market requires consumers to access information on offers available, assess them and act on this information in line with their preferences. Some may have misconceptions, for example, thinking this is more time consuming or difficult to search than it really is.
    - **For those only engaging without using the internet, independent sources of information are limited and not well known.** Ofgem survey results in 2019 found that 30% of customers with no internet use were not confident in choosing the best energy deal for their household, as opposed to 15% of those who regularly use the internet.[17] Those on low incomes or from a lower social grade were also significantly less likely to use price-comparison websites (PCWs) when switching compared to those from higher social grades or higher incomes.[18]

[16] CMA, Tackling the loyalty penalty: Response to a super-complaint made by Citizens Advice on 28 September 2018: https://assets.publishing.service.gov.uk/media/5c194665e5274a4685bfbafa/response_to_super_complaint_pdf.pdf
[17] Ofgem, Consumer Survey 2019, Consumer Engagement Survey 2019 Data Tables, Table 341
[18] Ofgem, Consumer Survey 2019, Consumer Engagement Survey 2019 Data Tables, Table 227.

  - **Many customers do not have confidence in the results generated by PCWs.** The Ofgem Consumer Survey results from 2019 found that 30% of customers did not believe PCWs to be unbiased in the way they present energy deals.[19] The CMA Energy Market Investigation found that 43% of those who were not confident in getting the right deal through a PCW said they did not believe the results of the search, and 26% said they found the information was too complex and were unsure of what the right deal was.[20]
  - **Misconceptions of supply risk.** The CMA's qualitative research provided evidence that consumers may be concerned that switching could temporarily stop their energy supply.[21] The Ofgem survey data from 2019 found that 12% of people were concerned that something might go wrong and they might get cut off following a switch.[22]

- **Energy suppliers can easily segment customers into groups with different abilities to access information and engage with the market effectively.** By tailoring tariff offerings and marketing strategies to different consumers, for example those who are more price sensitive, some consumers are isolated from the benefits of competition.

There is growing evidence that default arrangements significantly affect consumer choice, which could be used to improve the effectiveness of competition

25. In a conventional market, consumers must choose between available options and engage in the decision - individuals tend to choose the option which maximises their own welfare. However, in markets like energy, where continuity of service is required, consumers must be able to access products without having to make active choices. In other words, some form of 'default arrangement' is necessary. Evidence from the behavioural insights literature indicates that these arrangements can have significant impacts on consumer outcomes, with a tendency for many consumers to rely on the default option, rather than make an expressed choice themselves. This makes considering the most appropriate default arrangement designs and using evidence from real-world behavioural insights to inform this, a critical part of achieving the best outcomes for consumers.

26. A study on disengaged consumers by the Centre for Competition Policy (CCP) at the University of East Anglia provides a comprehensive discussion of the key factors

[19] Ofgem, Consumer Survey 2019, Consumers Engagement Survey 2019 Data Tables, Table 306
[20] CMA, Energy Market Investigation, Final Report: Appendix 9.1: CMA domestic customer survey, Page A9.1-11
[21] CMA, Tackling the loyalty penalty: Response to a super-complaint made by Citizens Advice on 28 September 2018. Page 24.
[22] Ofgem, Consumer Survey 2019, Consumer Engagement Survey 2019 Data Tables, Table 309.

underpinning the strength of default options in retail markets.[23] They identify three core mechanisms through which default options influence consumer choices:[24]

- Implied endorsement, where people perceive the default as the recommend option
- Cognitive biases, for example where people prefer the status quo as they are loss-averse when making decisions
- Effort, where people may not wish to exert the perceived effort required, potentially leaving the decision too late if it is perceived as too difficult.

27. Other authors have drawn similarities between the preference of defaults and social norms. Individuals often act in line with social norms, and evidence suggests that people may perceive the default option to be the social norm, and act in accordance with this.[25, 26]

28. There are links between these insights and the increased role of 'nudges' and similar practices in policy design globally.[27] Changes to the way that choices are presented to consumers can have a significant impact on the decisions that are taken, and there is a potential role for policy to identify ways of steering people towards decisions that may be better for them as an individual or for the community.

29. There are a range of global and UK-based examples of policy decisions that apply these insights to problems relating to situations with 'defaults'. For example, the Pensions Act 2008 required employers to automatically enrol employees onto a qualifying pension scheme, with firms also required to contribute. This was phased in from 2012, and employees were able to opt-out if they wished. As a result of the presentation of auto-enrolment as the default, from 2012 onwards there has been an increase in total membership of defined contribution occupational schemes from 2.1 million in 2011 to 21 million in 2019.[28] Further, in the first six months, participation rates in large firms rose from 61% to 83%.[29] Recent policy changes on organ donation in Wales (2015), England (2020) and Scotland (2021) also transform the default, in this instance so that everyone is considered an organ donor unless they opt-out.

[23] Centre for Competition Policy 2017, Collective Switching and Possible Uses of a Disengaged Consumer Database. Pages 26-27 http://competitionpolicy.ac.uk/documents/8158338/19064125/Collective+Switching+Report+-+August+2017.pdf
[24] Smith et al. (2013). Choice Without Awareness: Ethical and Policy Implications of Defaults https://www.researchgate.net/profile/Daniel_Goldstein3/publication/270406512_Choice_Without_Awareness_Ethical_and_Policy_Implications_of_Defaults/links/56f1ced508aed354e56fc3e1.pdf as cited in CCP 2017.
[25] Deutsch and Gerard (1955). A Study of Normative and Informational Social Influences upon Individual Judgement. https://motamem.org/wp-content/uploads/2016/12/social-conformity.pdf as cited in CCP 2017.
[26] Everett et al. (2015). Doing good by doing nothing? The role of social norms in explaining default effects in altruistic contexts. https://onlinelibrary.wiley.com/doi/pdf/10.1002/ejsp.2080 as cited in CCP 2017.
[27] Nudge: Improving Decisions about Health, Wealth and Happiness by Thaler and Sunstein (2008).
[28] ONS Occupational Pension Scheme Survey 2019, Table 3. https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/datasets/occupationalpensionschemessurvey
[29] DWP (2013). Automatic enrolment: Qualitative research with large employers report. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/254182/research-report-851.pdf

30. Internationally, there are also examples of its application in energy specific contexts. For example, several jurisdictions, including Ontario (Canada), Spain, and several US states have adopted time-varying electricity pricing as the default as a potential tool to encourage consumers to shift their demand profiles to reduce the total costs and/or carbon intensity of their electricity sectors.

Policy Objectives

Key objectives:

31. The overarching objective of policy in this area is to ensure that domestic consumers do not face unjustifiably high prices for energy – an essential service – and that vulnerable consumers are not disproportionately impacted by higher prices. Deeply and widely embedded competition is the most effective and sustainable way to keep prices low for all consumers. However, where the market and policy conditions for effective competition are not yet in place, proportionate price protection may be necessary.

32. This can be summarised through the combination of an economic objective and an equity objective:

- Improve the effectiveness of competition in the domestic retail energy market
- Protect vulnerable consumers from unjustifiably high energy prices while sustainable effective competition develops

33. The market failures which give rise to the loyalty penalty may also be closely linked to factors which could limit the ability of some consumers to reap the benefits of the shift towards a smarter, net zero consistent energy system. As such, we will continue to consider the consistency of options with a wider objective of increasing consumer uptake and engagement with products and behaviours made possible by changes in the wider energy system.

Options Analysis

34. Given the nature of the market failures discussed above, there are different mechanisms through which policy can seek to tackle the loyalty penalty:

    a. Overcome barriers to effective engagement by consumers;

    b. Remove the need for active consumer engagement as a prerequisite for effective competition;

    c. Directly target the excessive charging that arises as a result of the market failures

35. These mechanisms are not mutually exclusive and may be used in combination as part of a strategy. The first two can be seen as mechanisms to tackle the underlying causes of the loyalty penalty, whereas the latter is focussed on tackling the outcomes.

Option 1: Do nothing

36. A ‘do nothing’ scenario would leave existing and planned policies in the energy retail market as the sole measures to improve the effectiveness of competition and to protect vulnerable consumers from impacts of the loyalty penalty.

37. Key existing measures to remove the barriers for consumers to engage with the market include Ofgem’s Faster and More Reliable Switching Programme ; the Midata programme and the smart meter rollout.[30] These measures will take time to implement, and subsequently to have their desired impact on the effectiveness of competition. As discussed in the rationale for action section of this document, the nature and scale of the market failures which contribute to the loyalty penalty have strong links to aspects of consumer behaviour and phenomena such as cognitive biases. This makes it likely that measures that focus largely on technical barriers to engagement will not be sufficient to bring about the broad-based competition needed to overcome the loyalty penalty and to protect vulnerable consumers in particular.

38. In the ‘do nothing’ scenario, the default tariff cap will expire at the end of 2023 at the latest. In the absence of effective competition, this would be expected to have negative consequences for large numbers of customers (likely millions of households), including many in vulnerable situations. The revenues, and profitability, of some suppliers may increase as a result, but only through being able to charge higher prices to default tariff customers as a result of the market failures discussed above.

39. Doing nothing and allowing the cap to expire would therefore not achieve the equity objective or the economic objective. As this option alone is not expected to meet the policy objectives, we present three alternative options below.

Option 2: Enable the government to extend the temporary price cap on default energy tariffs beyond the end of 2023, if conditions for effective competition are not in place

40. The extension of any price cap would remain contingent on assessments of the effectiveness of competition in the energy retail market. Similarly, the methodology for determining the level of any cap would continue to be for Ofgem to determine. For the purpose of this document, the price cap is assumed to be set based on the same principles as the current cap. These are based on legislation which requires Ofgem to protect future and existing customers on default tariffs and in doing so have regard to, among other things, the need to allow suppliers to compete effectively for domestic customers and to ensure that efficient suppliers can finance their licenced activities.

[30] As per footnote 3, the Midata programme is currently on pause.

In a market that lacks effective competition, a price cap will lead to lower energy tariffs for default tariff customers compared with doing nothing once the current default tariff cap expires

41. In the absence of effective competition, default tariff prices for many customers would otherwise be above the level of the cap. As a result, a price cap will lead to price reductions for households on these tariffs. This benefit may be experienced as an increase in disposable income to spend on non-energy goods and services, and/or slightly increased energy consumption through keeping a warmer home, for example.

42. This effect is likely to produce equity benefits, given the disproportionate impact of the loyalty penalty on consumers in vulnerable situations, including those with lower incomes.

43. The scale of the benefit to these consumers due to any continuation of the cap will depend on the market circumstances at the time and the decisions made by Ofgem in determining the level of the cap. The maximum benefit a cap can deliver to these customers will depend on the extent of the consumer detriment that default tariff customers would otherwise face – how much more they pay than in a hypothetical competitive market.

44. Since 2016, there have been several assessments of the size of the consumer detriment. The CMA's 2016 Energy Market Investigation found an annually increasing detriment, as supported by Ofgem's 2018 Final Impact Assessment for the current Default Tariff Cap which found a similar scale of detriment of around £1.5bn per year in 2017. The same exercise led to the conclusion that a typical household on a default tariff would save £76-120 per year following the introduction of the cap, with an estimated £1,233m per year aggregate savings across households.[31] [32] Since a price cap is currently in force, it is challenging to provide an updated assessment. However, since there has been limited change to underlying competitive dynamics since Ofgem's assessment, we consider that this remains a useful indicator of the likely scale of benefit.

Lower default tariff prices mean lower revenue and profit for some suppliers

45. Energy suppliers overall will experience a reduction in revenues from default tariffs - the direct result of reduced tariff prices for their customers. Those suppliers who would otherwise charge the highest tariff prices and with larger proportions of their customers on default tariffs are likely to be most significantly affected. As with the consumer benefit from lower tariff prices, given the current presence of the price cap, isolating the direct impact of the cap on supplier revenues is challenging. The precise impact will depend on market circumstances and decisions made by Ofgem with regard to the level of the

[31] Ofgem (2018) Press Release, https://www.ofgem.gov.uk/publications-and-updates/energy-price-cap-will-give-11-million-fairer-deal-1-january. This is the range between the average and maximum saving for dual fuel customers.
[32] Ofgem (2018) Final Impact Assessment: Default Tariff Cap, Table A11.12, Page 70.

cap. Ofgem's Impact Assessment for the current formulation of the price cap estimated an aggregate direct impact on supplier revenues of £1,174m per year.[33]

46. We do not anticipate that the impact of a cap on supplier profits has a one-to-one relationship with the revenue impact. The CMA's analysis in the Energy Market Investigation found that the large energy suppliers were able to maintain material inefficiencies – valued at around 40% of the total consumer detriment identified. A price cap set at the appropriate level has the potential to act as a quasi-competitive lever to encourage such suppliers to make and maintain efficiencies, limiting the impact on their profitability all else equal. Since the announcement of the price cap's initial introduction, large suppliers have announced and begun the implementation of substantial efficiency programmes. For instance:

- Centrica, the owner of British Gas, gas announced and begun to implement plans to deliver £2bn of cumulative efficiencies;
- E.ON and npower have become part of the same group of companies and announced and begun to implement plans to consolidate the business and modernise their platform;
- SSE has been acquired by and incorporated into the OVO group.

With careful design, a price cap on default tariffs can operate alongside strong competition in other market segments

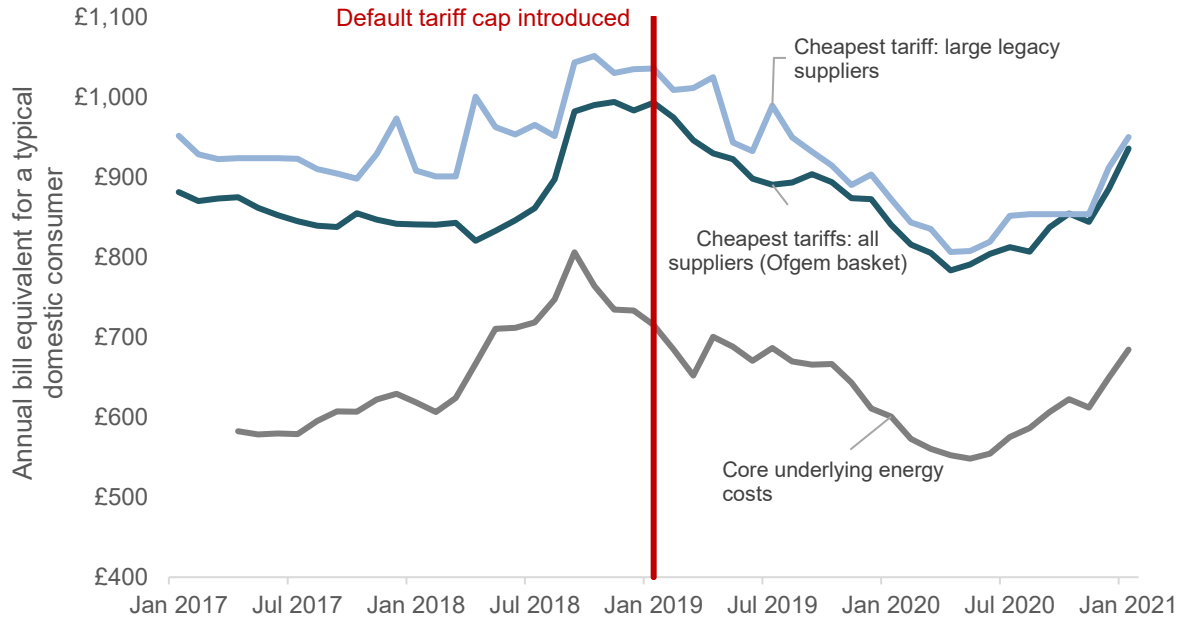
47. While there is significant evidence of weak competition and a risk of consumer detriment in the default tariff market, for those who engage the wider domestic retail energy market has been highly competitive for many years. There are a large number of suppliers (currently around 55) who compete on the basis of price and other factors.

48. To maintain healthy competition in this market segment, the current price cap legislation puts a duty on Ofgem to consider factors critical to competition when setting the cap level. Most importantly there is a duty to have regard to the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; and the need to maintain incentives for domestic customers to switch to different domestic supply contracts.

[33] Ofgem (2018) Final Impact Assessment: Default Tariff Cap, Table A11.5, Page 46.

49. There is only a limited period since the price cap was introduced in January 2019 over which to consider potential effects on competition outside the default tariff segment. However, there are several key observations which provide some early insight. In particular, there is evidence that the close relationship between underlying costs and tariff prices outside the default market has continued since the cap's introduction, and there is no clear evidence of any significant change to the mark-up charged by suppliers in this market segment. This can be seen in the figure below, which shows the last four years of cheapest tariff prices, both among the large legacy suppliers, who are most likely to be affected by the cap, and across the whole market; compared to an assessment of the core underlying costs of energy supply – wholesale prices, network charges, and environmental and social obligation costs. [34]

Figure 3: Cheapest dual fuel energy tariffs by supplier type and underlying costs since April 2017 (source: Ofgem retail market indicators)

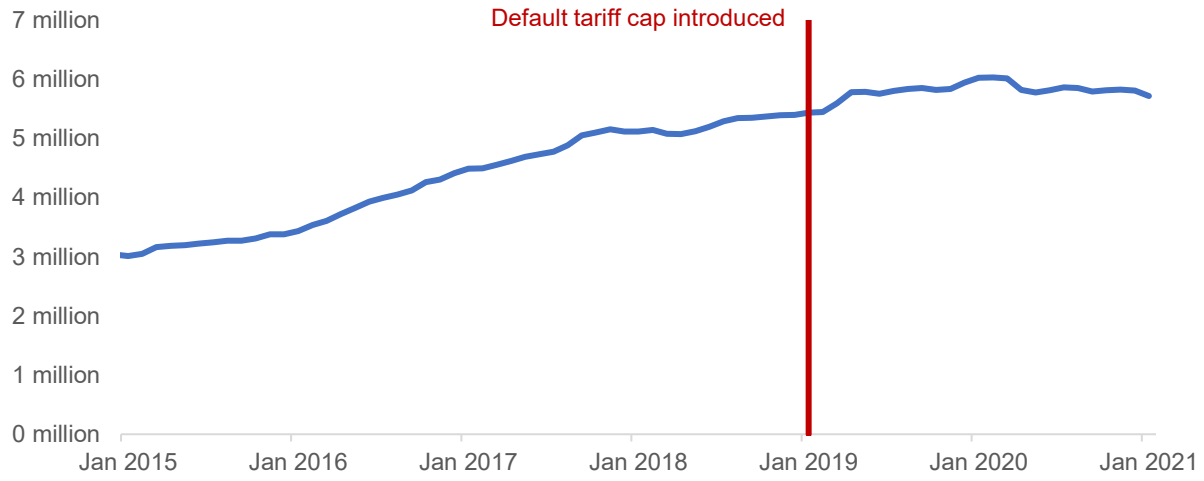


50. In the current market structure, switching is a significant driver of competition, since it is the possibility of consumers changing supplier that provides competitive pressure. There is strong historical evidence that the difference in price between the tariffs to which consumers default and the cheapest tariffs available has a close relationship to switching habits. As such, it was generally expected that the introduction of the default tariff cap would lead to a significant reduction in the numbers of customers switching. For example, analysis by Ofgem suggested that the expected narrowing of the differential as a result of the price cap could lead to a reduction of switching rates of between 10% and 40%, all else equal.[35]

[34] This assessment is based on average forward wholesale gas and electricity prices, covering the subsequent four quarters (sourced from ICIS Heren) and weighted by season and baseload vs peak based on parameters used by Ofgem in the setting of the default tariff cap; and network charges and environmental and social obligation costs as per Ofgem's Default Tariff Cap methodology for the relevant six-monthly period.
[35] Ofgem, Default Tariff Cap: Decision. Final Impact Assessment. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_11_-_final_impact_assessment.pdf

51. Despite this, switching rates reached record highs after the cap was introduced in 2019, and have so far remained at levels well above typical levels from recent years, though with any increase likely at a slower rate than in some recent years. This can be seen in the figure below. There are confounding factors in both directions – with wholesale price patterns leading to large price differentials in much of 2019 and early 2020 and the COVID-19 pandemic appearing to lead to reduced levels of consumer market engagement in a variety of markets, including energy and banking.[36] However, this provides early indicative evidence that a market with price protection for the most disengaged consumers can be consistent with continued competition in other market segments.

Figure 4: Total number of domestic electricity switches in the past 12 months (Source: Ofgem retail market indicators)



However, a price cap alone will not create the conditions that will extend effective competition to the default tariff market

52. While a price cap can directly limit the extent to which default tariff customers are charged excessively, it is less likely to bring the wider benefits across the market that come from competition between suppliers.

53. A price cap relies on the regulator to determine an appropriate cap level, based on an assessment of underlying costs. This is a significant and complex undertaking, necessarily, in large part, reliant on historic evidence of costs from suppliers. Exactly determining the level of 'efficient' costs is not possible, and the exercise relies on approximation based on extensive, but imperfect, information. In contrast, effective competition can provide a dynamic mechanism, based on information revealed through market processes, to ensure prices for consumers reflect efficient costs, as well as other attributes that may be valued.

[36] Citizens Advice. The loyalty penalty in essential markets. https://www.citizensadvice.org.uk/Global/CitizensAdvice/Citizenship%20Publications/Loyalty%20Penalty%202%20Year%20Update%20(1).pdf

54. A price cap in a market without effective competition may also mean many customers remain with suppliers despite persistent operating inefficiencies in their business, or relatively poor levels of customer service.[37] As such, a cap would not necessarily be associated with the wider benefits that may be brought through an increase in the ability of more efficient suppliers to enter the market and grow their market share. Therefore, it is unlikely that by itself legislation enabling the price cap to be extended for longer alone would meet the economic objective of improving the effectiveness of competition in the default tariff market. As such, we have considered alternative options that aim to tackle the underlying causes of the loyalty penalty, rather than simply limiting its impacts.

A price cap leads to administrative costs for Ofgem and suppliers, but these are likely to be small in comparison to the size of the loyalty penalty

55. A price cap will require administration from both Ofgem and suppliers affected by the cap. Ofgem will incur costs to develop the methodology, keep it up-to-date and enforce compliance. Suppliers will face administrative costs from the provision of information to Ofgem as part of the processes to maintain the methodology and from updates to the cap level where they necessitate price changes for their customers.

56. These administrative costs are expected to be low in comparison to total impacts. Given that a price cap has been in force since 2019, it is likely that suppliers and Ofgem will have gained familiarity with the processes and put in place procedures for features such as regular price updates. The precise extent of the cost will depend on the approach adopted by Ofgem in setting the cap in future years. Nonetheless, providing sufficient notice of any plans to extend the price cap legislation is likely to help ensure the familiarity suppliers have with the existing administrative processes are not lost.

Option 3: Introduce an opt-in switching scheme and test opt-out based reforms to the default arrangements

Opt-in switching

57. Opt-in switching would involve a form of direct communication by a delivery body with customers who have not switched energy tariffs for an extended period, and remain on default tariffs as a result. The communication is a prompt for the consumer to consider their choices in the market and can take several different forms depending on scheme design.

Opt-in switching schemes can play a significant role in overcoming some of the key barriers to effective consumer engagement with the market.

58. In general, a market where individuals can operate with clear, accurate information should enable consumers to make decisions which maximise their own welfare. Despite this, as discussed in the rationale for change, there is a large body of evidence that shows that certain features of the domestic energy retail market, in conjunction with

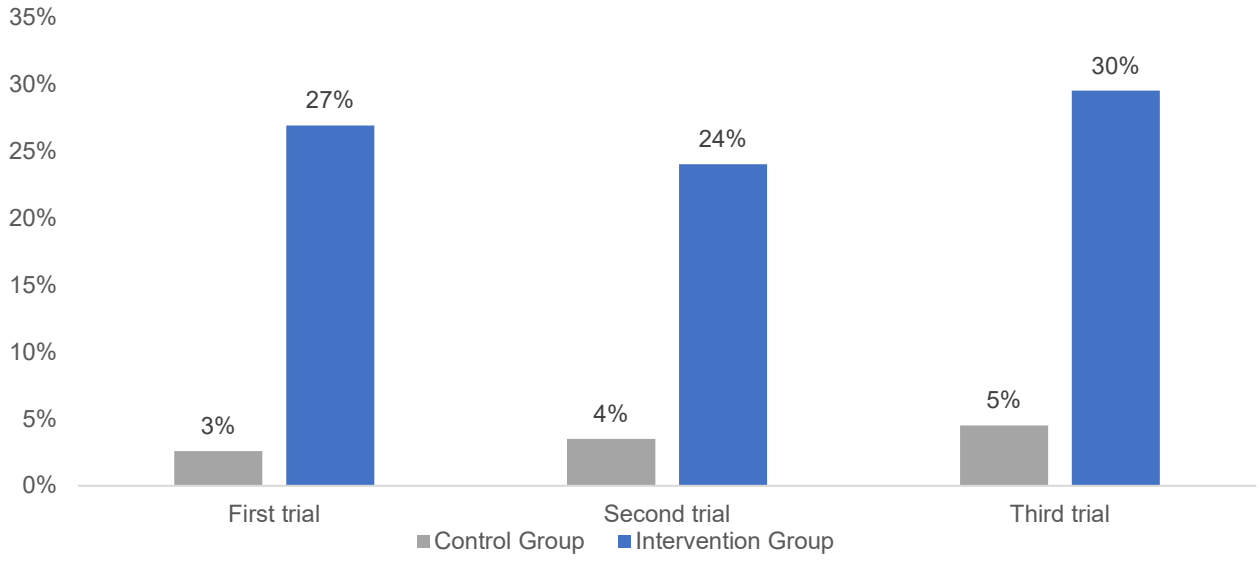
[37] While Ofgem monitor the market for compliance with customer service requirements, customer service and consumer satisfaction varies between suppliers.

behavioural biases mean that this does not reflect the experience of a large group of consumers.

59. Many of these relate to the way consumers receive information about the market and the perceptions that result about the choices available to them. By drawing on behavioural insights and a detailed understanding of the most effective ways to communicate with consumers about their choices, an opt-in switching scheme could help remove these barriers to effective competition. Such opt-in schemes effectively make it easier for consumers to understand and engage with the choices available to them, including those to switch onto tariffs that can offer savings and/or better suit their needs. The Ofgem Collective Switch trials, for example, was an end-to-end process including data sharing, removing the hassle of searching, offering a trusted intermediary and handholding support for the switching process itself, all of which were important aspects of the scheme design. Opt-in would strive to tackle the second key cause of the loyalty penalty identified by the CMA, as set out in the rationale for change.

60. Evidence from Ofgem's Collective Switch trials highlight the potential impact of opt-in schemes to facilitate consumer engagement. These trials found that a significant number of customers who have not switched energy tariff for many years choose to do so when provided with information in the form of simple, well-designed letters. [38] They were able to successfully overcome barriers to switching for a large subset of consumers who had been on default tariffs for a long time. Between 19-30% of consumers who received opt-in communications chose to switch their tariff during the trial, 5 to 10 times more than the rate observed in the control group, where just 2.6-4.5% of consumers switched tariff during the 7-week trial period.[39] The success of opt-in

Figure 5: Switching rates in the Ofgem Collective Switch trials from 2018-2019 (Source: Ofgem collective switch trials)



[38] These letters were designed using behavioural insights and consisted of many components. These design elements are discussed in more detail in this Ofgem publication: https://www.ofgem.gov.uk/system/files/docs/2019/09/collective_switch_slides_for_publication.pdf
[39] https://www.ofgem.gov.uk/publications-and-updates/ofgems-collective-switch-trials

interventions across the trials is highlighted in the figure below, where switching rates were substantially higher for all interventions groups.

By enabling larger numbers of consumers to engage effectively with the market, opt-in switching will reduce the numbers of customers at risk of exposure to a loyalty penalty

61. Opt-in switching is expected to have both direct and indirect impacts on consumer energy bills. The direct impact is through the increased numbers of consumers switching away from default tariffs towards less expensive tariffs. The indirect impact is from the effect of increased consumer engagement on the competitive pressures faced by suppliers to attract and retain customers, driving down prices in the longer-term. Nevertheless, the opt-in rollout could exert sufficient competitive pressures on the default tariff market to achieve the economic objective.

62. By engaging a wider group of consumers in informed decisions about their energy choices, it is expected that the number of customers experiencing a loyalty penalty will be significantly reduced. In 2018, before the current price cap was introduced, the average default tariff for a typical customer was around £280 more expensive than the average of the 10 cheapest fixed tariff offerings available.[40] Given 60% of customers remain on default tariffs under the current policy environment, if an opt-in switching scheme were able to achieve a similar switching rate to the Ofgem trials of 19-30%, there is scope for a considerable direct saving via bills for a large number of consumers.[41] The scale of savings available to individuals is likely to vary over time and may itself be affected by the roll-out of switching schemes, depending on the market structure and nature of competition in the wider market at the time.

63. Changes to the market composition over time will depend on the choices made by consumers, including those who take part in an opt-in switching scheme. In the longer term, by increasing the size of the pool of customers engaging with the market, opt-in switching has the potential to increase the potential growth prospects for competitive firms in the market. While further real-world evidence is needed to corroborate, in the 17 months following Ofgem's Collective Switch trial, it was observed that 51% of switches were to an external supplier and 49% to another tariff offered by the same supplier.[42] It was also found that the majority of switches following the trial period were to small or medium suppliers, with only around a third of external switches made to large suppliers.[43] To achieve the best outcomes for consumers in terms of competition, it will

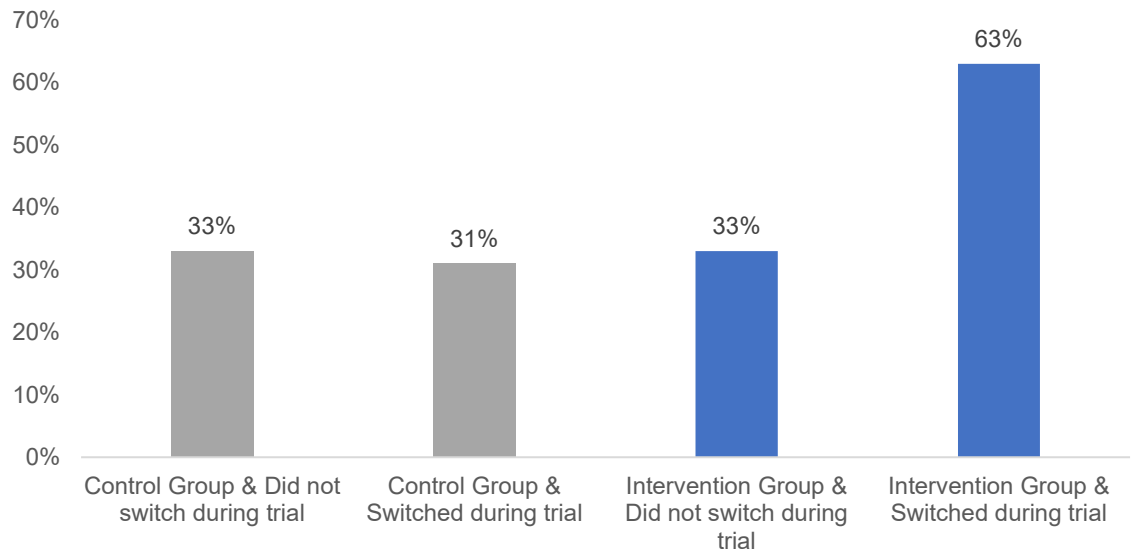
[40] Ofgem, Retail Market Indicators, updated regularly.
[41] Ofgem, All supplier RFI data.
[42] Ofgem, Prompting Sustained Engagement in Energy Tariff Switching, 2020, page 22, https://www.ofgem.gov.uk/ofgem-publications/167315
Of those who switched to the exclusive tariff via the price comparison website during the trial, 76% of customers switched to a tariff offered by a different energy supplier and 24% switched tariff while remaining with the same supplier in the following 17 months. This may have resulted from the re-prompting campaign run by the price comparison site.
[43] Ofgem, Prompting Sustained Engagement in Energy Tariff Switching, 2020, page 22

be important to ensure a wide range of suppliers, including smaller suppliers, can participate in any scheme on a level-playing field.

Re-prompting consumers after the initial opt-in may lead to increased long term market engagement

64. Building re-prompting of consumers, after the initial switch has taken place, into an opt-in switching scheme may also be useful for long-term market engagement. In Ofgem's follow-up studies to the first Collective Switch trial, re-prompting led to greater long-term engagement for those who responded to the initial prompt.[44] Consumers who switched through the price comparison website that delivered the trials were re-prompted just before their new fixed term tariff end date, and their subsequent switching was much higher than the consumers who switched through other routes, who were unlikely to have been re-prompted. This is shown in the figure below, which highlights the successes of re-prompting in driving future market engagement amongst those who switched during the trial period, with 63% of those who switched during the trial switching again in the following 17 months.[45]

Figure 6: Switching rates in the 17 months following the First Collective Switch trial (Source: Ofgem collective switch trials)



65. Given ongoing consumer engagement with the energy market may be necessary to achieve the UK's net zero target, re-prompting is likely to be required in ensuring long-term market engagement resulting from more widespread opt-in rollout. Prompts to

[44] The subsequent switching rate for the control group (who received no prompt) was much lower, 31% of those who switched during the trial then subsequently switched and 33% who didn't initially switch then went on to do so during the 17 month period. Of those who received the initial prompt but didn't switch during the trial, only 33% switched in the 17 subsequent months. https://www.ofgem.gov.uk/publications-and-updates/prompting-sustained-engagement-energy-tariff-switching

[45] Within the 63% who switched in the intervention group, 79% did so via the price comparison website, who undertook a big re-prompting campaign towards the tariff end date. 69% of these customers subsequently switched and of these, the more marketing material the customer signed up to, the more likely they were to switch. Among those who switched using another external source, only 38% switched which was only slightly higher than the 33% who switched in the following 17 months even if they didn't switch during the intervention.

specific tariff types, such as time of use, or green tariffs, may be another method to align with these goals.

By increasing competition, an opt-in switching scheme is likely to negatively affect the revenues of some suppliers

66. Supplier revenues from the default tariff segment of the market would be expected to be lower, relative to the do nothing, as increased competition changes the incentives faced by suppliers, including to offer lower prices. While this impact is not intended in and of itself, it is a prerequisite for a policy that overcomes a persistent loyalty penalty. The opt-in rollout is intended to lead to a transfer of some of these revenues into a benefit for consumers on default tariffs, many of whom are likely to be in vulnerable circumstances.

67. As opt-in switching introduces more competition and reduces the ability of suppliers to charge excessively, there may be reduced desire among some suppliers to offer 'loss-leading' tariffs for new customers as part of a longer-term pricing strategy – often referred to as 'tease and squeeze'. The extent to which this will occur is uncertain at this stage.

The implementation of an auction process for determining 'collective tariffs' in an opt-in scheme may play a key role in determining the impact

68. If an auction-style system is created as part of the scheme design (as discussed in the consultation on switching schemes), then suppliers would be likely to incur a cost to obtain customers as part of the scheme, both from administrative costs and any transfers that result from the competitive process. The extent to which these costs exist, and their scale, will depend on the final scheme design – particularly the design of any auctions. However, we would anticipate that suppliers would not bid an amount greater than that which they would serve to benefit from through the acquisition of those customers. In other words, suppliers would not bid unless they could be certain that their bid would yield them a net benefit.

69. An auction system may have the detrimental impact of reducing the ability of small suppliers to compete, which may limit the competitive pressures they can exert on the market and, in turn, default tariff prices for consumers. They may not have the capital required to out-bid the larger, more mature suppliers, and there is the potential they are disproportionately impacted by this approach. There is the option, for example, of creating an auction with multiple winners, which may help smaller suppliers compete by only bidding for as many consumers as they are able to accommodate.[46] The scheme design of any auctions would be determined at a later date, once further evidence is gathered.

[46] This approach is discussed in more detail in Annex C2 of the Domestic Energy Retail Consultation Document https://www.gov.uk/government/consultations/energy-retail-opt-in-and-testing-opt-out-switching

Subsequent design decisions will affect how an opt-in switching scheme affects supplier administration costs as well as the market for price comparison and similar services

70. Suppliers may face some additional administrative costs resulting from the rollout of an opt-in scheme. The additional costs incurred directly related to the scheme may include identification of consumers within the scope of the scheme and sending letters or other communications to consumers on default tariffs, which is not significantly different to their existing engagement with consumers. However, it is likely that there will be significant overlap with ongoing supplier practices, including those required by existing regulation, such as billing and other consumer notifications.

71. There may also be some additional administrative costs for suppliers associated with an increase in the number of consumers switching supplier. Depending on the scheme design, these will fall between the delivery body, existing and gaining supplier. To a significant extent, it is expected that many of these costs will be priced into consumer tariff prices.

72. Suppliers may face some additional cost to familiarise themselves with the opt-in systems. We are still considering which bodies should deliver each function, and the consultation asks for stakeholder's views on some decisions, but our current proposals involve the delivery body facilitating many of the administrative functions.

73. Design decisions on delivery bodies for an opt-in scheme will be critical in determining the impact of the scheme on ancillary retail markets, such as the market for price comparison services. For example, for the options that involve a price comparison service as the scheme delivery body (as was the case in the Ofgem Collective Switch trials), there may be impacts on competition in that market given the potential scale of the undertaking. This factor will need careful consideration, for example in the design of any exercises to procure delivery body services.

An opt-in scheme is unlikely to lead to effective engagement among all customers on default tariffs, given the role of default arrangements in driving consumer behaviour

74. As discussed in our rationale for change, there are behavioural factors beyond barriers to information and engagement that explain consumer behaviour in markets such as energy. It is our expectation that the effect of default arrangements on consumer behaviour will continue to mean a significant number of consumers do not effectively engage, even in a market with a successful opt-in switching scheme.

75. As highlighted by the Centre for Competition Policy in their review of existing evidence, and from Ofgem's Collective Switch trials, even the most successful opt-in schemes are unlikely to lead to engagement by a majority of those who have previously been persistently disengaged. While Ofgem trials did not collect detailed demographic data, there are reasons to expect that the hardest to reach customers may be more likely to be in vulnerable circumstances, given the additional barriers they may face. As such, it

is not certain that opt-in switching alone would achieve the equity objective of protecting vulnerable consumers, either in the immediate term or as it reaches more widespread rollout. Therefore, another option for potentially reaching the most vulnerable people may be required and is discussed below.

Opt-out testing

76. Default arrangements in the energy retail market ensure that customers receive continuity of service from the supply market when their fixed term tariff expires or when they move to a new home, providing security for those who do not engage with the market. However, as the CMA has identified, the existence of forms of default arrangements that involve auto-rollover or similar are a significant cause of loyalty penalties. Introducing elements of 'opt-out' into consumer energy choices – where a change in tariff or supplier can occur without the expressed choice of an individual consumer – may be an effective means to overcome the most persistent challenges to reaching a fully competitive market and tackling the loyalty penalty. This is because it can provide a mechanism for competition between suppliers even in the absence of expressed engagement by consumers.

77. Much of the impact of any opt-out scheme will depend heavily on subsequent design decisions - in particular, how consumer interactions with the scheme are designed, and how decisions are made about which tariffs consumers are 'switched to' if they do not opt-out, for example through competitive auctions. It will be important that the scheme design is carefully considered as policy development continues to ensure that it can deliver the best outcomes.[47]

Introducing an opt-out component to consumer choice would be likely to substantially increase the number of customers on tariffs exposed to competitive pressure

78. As discussed above, in the existing market, large numbers of consumers remain on default products for extended periods of time, despite the prospect of significant savings by switching. The latest available Ofgem survey data shows that 91% of default tariff (standard variable) customers have been on their tariff for more than a year, 78% for three or more years, and 64% having never switched tariff before.[48] While some customers may have a genuine preference for these tariffs from a supplier, this provides an illustration of the likely scale of the challenge for measures, such as opt-in switching, that rely on individual consumer engagement with the market to tackle the full breadth of the loyalty penalty.

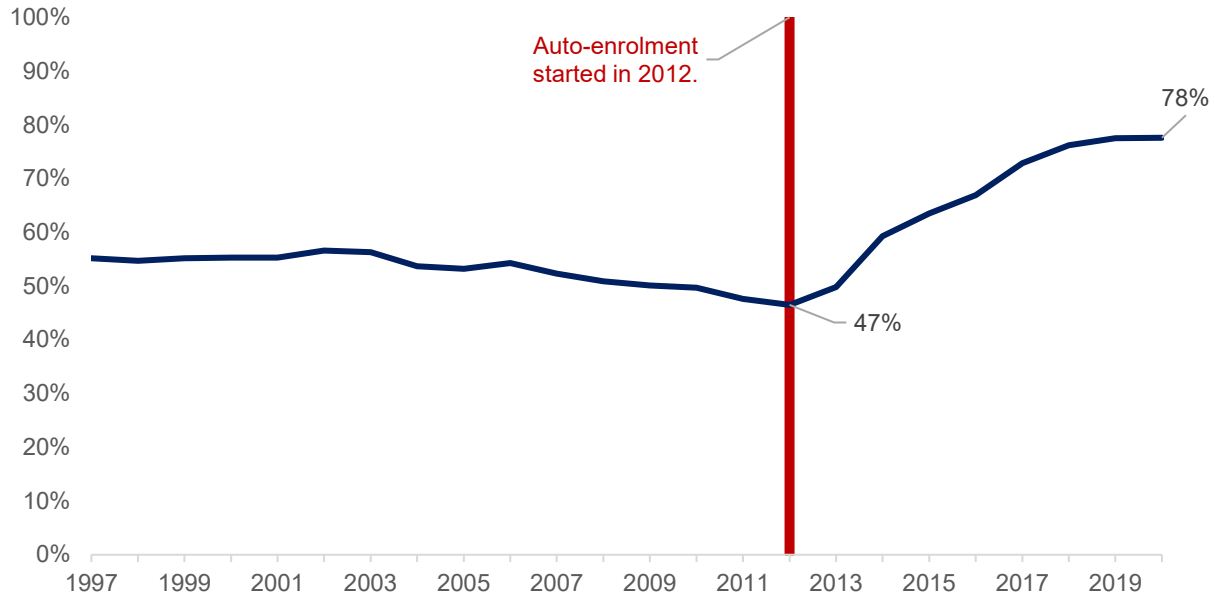
79. To overcome the full range of behavioural factors that contribute to excessive charging, elements of 'opt-out' arrangements may be necessary. A range of evidence, including that gathered by the Centre for Competition Policy indicates that opt-out based policies are likely to lead to a substantial increase in switching rates for the most persistently

[47] This is discussed further in Annex B of the Domestic Energy Retail Consultation Document.
[48] Ofgem 2019 Consumer Survey (Consumer Survey Data Tables, Table 155)

disengaged consumer group.[49] Real world evidence from other contexts illustrates the potential for significant positive impacts. For example, opt-out schemes for organ donation have been introduced in several jurisdictions, including in Wales since 2015,

Figure 7: Percentage of UK employees enrolled in workplace pensions, since 1997 (Source: ONS Employee workplace pensions in the UK: 2020 provisional and 2019 final results)

England since 2020, and Scotland since March 2021. Automatic enrolment in the UK pension market introduced in 2012 and was associated with an almost doubling of the number of employees participating in a workplace pension scheme.[50] The effectiveness of opt-out arrangements in the pensions sector is highlighted in the figure below.



80. A well-designed opt-out scheme would be expected to increase competition by ensuring that customers are on energy tariffs that they have either expressly chosen, by direct market engagement or opting-out of the scheme; or that have been determined through an externally organised competitive process, such as an auction.

81. Increasing the number of customers moving away from default tariffs would be expected to benefit some customers directly, where they are switched to lower priced tariffs; and others indirectly, through any competitive pressure that is exerted on suppliers to offer better value tariffs to customers who may otherwise switch through the scheme.

82. Through the policy development process associated with opt-out, including testing, we will develop a clearer understanding of the extent to which variations of opt-out switching could enable direct reduction on consumer bills as well as the mechanism through which the competitive forces indirectly impact on prices. At this stage we cannot

[49] Centre for Competition Policy 2017, Collective Switching and Possible Uses of a Disengaged Consumer Database.
[50] ONS, Employee workplace pensions in the UK: 2020 provisional and 2019 final results. https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/bulletins/annualsurveyofhoursandearningspensiontables/2020provisionaland2019finalresults

be certain of the total size of the benefit this would yield for consumers. Despite this, opt-out has the potential to achieve both the equity and economic objectives if trials and wider development work show it is scalable.

Opt-out has the potential to achieve both the equity and economic objective, but we need to build a larger evidence base before a real-world roll-out

83. While there is a range of evidence to suggest that opt-out schemes could be a potent force for improving competition, getting the design right so that it works for consumers will be critical.

84. Given the previously discussed disengagement in energy choices among many consumers in vulnerable circumstances, a system involving an opt-out has the potential to bring significant distributional benefits. To obtain evidence on the potential impacts on consumers of the introduction of opt-out choices and the extent to which opt-out can provide protection for the most vulnerable from excessive charging, the government's current proposal is that significant testing with consumers will be undertaken, ahead of subsequent decisions about a wider roll-out. As such, the number of consumers directly impacted by government proposals at this stage will be small and occur within a controlled testing context.

85. A key observation with any system involving a default arrangement, given the behavioural evidence presented, is that some consumers receive a tariff that differs from that which they would choose were they to engage actively. This may be true under an opt-out scheme (where customers are placed on a new tariff), as it is under the existing arrangements (where customers auto-renew onto a predefined tariff with their supplier). Nonetheless, to minimise the scale of any detriment that may result, it will be important to ensure that the policy is well-designed. In an opt-out system, this is likely to involve finding the most appropriate tools to ensure consumers understand the process, how to opt-out and can do so with ease. It will also be mitigated by the adherence of suppliers to regulatory standards surrounding customer service standards.

86. In light of this, at this stage there will be a particular focus in the design of testing on the consumer response to such a scheme, for example to understand the potential for anxiety associated with being switched without express consent, and how best to communicate with consumers in light of this. Broad consideration of these potential risks is built into the aims of opt-out testing in Section 3 of the Domestic Energy Retail Consultation Document, with consumer protection discussed in section 3.7 more specifically. This will be of particular interest, given that some customers may have a genuine preference for their existing tariff, as discussed above.

87. Through testing, there will be a particular focus on examining the potential impacts on vulnerable consumers, and to understand how an opt-out system can be best designed to meet their varied needs. In this way, the equity objective will remain a key focus of the policy design to prevent the most vulnerable from facing the impacts of a loyalty penalty.

There may be limited impacts to suppliers during the testing, but long-term impacts of wider rollout are not yet certain.

88. Given opt-out is only currently being considered at testing scale, the additional direct cost to suppliers will likely be small. The exact design of the trials has not yet been decided, but testing is expected to only directly impact a few suppliers through administration and familiarisation costs. In any case, these impacts are likely to be small, given the desire to minimise unnecessary disruption and wish to focus on the consumer experience, meaning tests are anticipated to be small in scale. The extent of these small direct costs will also depend upon whether all suppliers or only a subset of suppliers are targeted during testing.[51] To the extent that consumers move to different suppliers or cheaper tariffs during trials as a result of the opt-out mechanisms, there will also be small indirect impacts on supplier revenues.

89. In the longer term, there may be more substantial indirect impacts from introducing opt-out switching into default arrangements. In particular, bringing increased levels of competition to the market has the potential to reduce the revenues recovered from default customers by some suppliers, both by increasing the numbers of consumers moving to cheaper tariffs and potentially by creating incentives for suppliers to offer more competitive default tariffs in the first place. At the same time, by significantly increasing the number of customers for whom suppliers actively compete, such a scheme has the potential to benefit the most efficient suppliers, who will be well-placed to attract a larger customer base.

Option 4: Enable extensions of the price cap until conditions for effective competition are in place, while rolling out opt-in and testing opt-out switching (Preferred option)

90. Extending the price cap alone will not achieve our economic objective, and the lead times on introducing opt-in and opt-out testing limit the possibilities for delivering against both our economic and equity objectives in the short-term. Our preferred option is therefore to implement all three. In this way, vulnerable consumers will be protected from the loyalty penalty in the interim, while we and Ofgem introduce market reforms to help facilitate competition and tackle the underlying causes of loyalty penalties.

Enabling extensions of the price cap can protect consumers from a significant loyalty penalty, but would not increase competition

91. In the short-term, opt-in and opt-out trials may not sufficiently protect vulnerable consumers, nor drive the competition required to achieve both the economic and equity objectives. The mechanisms by which these switching policies can achieve these objectives, namely tackling the causes of the loyalty penalty, will take considerable time to bring to full scale. Therefore, the price cap can protect consumers, including the most vulnerable, from the impacts of the loyalty penalty in the shorter term.

[51] A more detailed discussion of these points around testing design is discussed in section 3.3 of the Domestic Energy Retail Consultation Document.

92. As discussed under option 2, legislation to enable extensions of the price cap beyond 2023 will directly protect default tariff customers from a loyalty penalty. This will ensure lower energy prices for many default tariff customers.

93. While potential extensions of the price cap would provide immediate protection to customers, it is unlikely that direct price intervention is an effective mechanism to substantially increase consumer engagement or otherwise drive competition in the default tariff market in either the short or longer term. This is because it does not by itself tackle the underlying causes of the loyalty penalty necessary to ensure more widespread change. Therefore, while enabling the price cap to be extended for longer would meet the equity objective, further measures will be needed to ensure we meet our economic objective.

In the medium term, consumer market engagement may increase via opt-in switching, increasing the effectiveness of competition

94. To tackle the causes of a loyalty penalty, and protect vulnerable consumers in the future, it is necessary to remove the barriers to consumer engagement with the market to drive competitive forces in the default tariff market. Incrementally rolling out opt-in switching is one method of potentially achieving this in the medium to longer term.

95. As discussed under option 3, Ofgem's trial evidence strongly suggests that effective communication of an opt-in switch option can significantly increase switching from default tariffs amongst the long term disengaged. This evidence also suggests this effect may continue into the long run, especially where customers are re-prompted.

96. As highlighted in option 3, there will be direct and indirect competition benefits from introducing opt-in switching. We therefore expect that opt-in switching can make a significant contribution to achieving both our equity and economic objectives.

97. However, as discussed above, opt-in switching will take time to scale incrementally before consumers fully benefit, and the objectives can be achieved. As discussed under option 3, the most disengaged customers may continue to be disengaged even with the support an opt-in scheme provides. Therefore, opt-in switching may not offer the same overarching protection to vulnerable customers as a price cap. In this way, vulnerable customers who would stand to benefit the most by switching from an expensive default tariff, may continue to face a loyalty penalty and the equity objective may not be met in the longer term. This need could be filled by opt-out switching, but testing is required to help test its efficacy.

In the longer term, the most disengaged consumers may benefit from opt-out, but scheme design will determine supplier costs and the impacts on competition

98. Opt-out testing will focus on addressing the current nature of default arrangements as an underlying cause of the loyalty penalty in the energy retail market. As discussed in the rationale for change, by presenting the default option as a switch that consumers can opt-out of, the disengaged, and the most vulnerable, could benefit, as people often accept the default.

99. As explained under option 3, opt-out has the possibility to offer the widespread protection from the effects of the loyalty penalty, as offered by the price cap, while also driving the effective competition required to tackle its underlying causes, without relying on consumers to make an expressed choice, as with opt-in. However, it is important to be clear that the trials themselves do not have the capability to achieve these outcomes, only a wider rollout, if the trials prove to be successful.

100. There is less empirical evidence on the success of opt-out, including on the consumer experience of an intervention to their tariff choice, than that supporting opt-in schemes as discussed under option 3. For this reason, it is necessary to start by testing this intervention, for which primary legislation is required. Given this requirement, the potential benefits of an opt-out system would not be realised for considerable time and will take time to scale to an impactful level. The direct supplier impacts of this are discussed under option 3.

101. While, therefore, opt-out reforms to the default arrangements could provide the best long-term solution for tackling the loyalty penalty, further evidence is needed, and in the meantime, allowing extension of the price cap beyond 2023 and rolling out opt-in switching form the best overarching strategy for intervention in the energy retail market. This will work alongside the other measures such as Ofgem's Switching Programme; the smart meter rollout; Settlement Reform; and smart data initiatives, as mentioned in the background section, to remove the barriers to market information and engagement.

Monitoring and Evaluation

102. A comprehensive M&E plan will be devised through the gradual scaling up of opt-in switching and the testing of opt-out switching. Key features such as switching rates, consumer perceptions, numbers on default tariffs and tariff prices will all be monitored. This will enable an evaluation of how effective the measures have been in achieving the equity and economic objectives. Who is responsible for this monitoring, and how this data is collected will be determined during the final scheme design process, following consultation. Timings on post-implementation review processes will be set out more clearly in any subsequent final stage impact assessments. Critically, monitoring and evaluation will play a key role in informing a flexible approach to the future design of the schemes, ensuring that we continue to tailor policy to the changing needs and attitudes of consumers.

103. For the price cap, as under the existing legislation, extension of the cap will be contingent on an assessment of the conditions for effective competition in the market.

This publication is available from: https://www.gov.uk/government/consultations/energy-retail-opt-in-and-testing-opt-out-switching

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