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Agenda

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Consumer decision-making in complex markets: Ofgem's Retail Market Review

In November 2010, Ofgem, the energy regulator for Great Britain, announced a review of the retail energy markets. Four months later, the results were published, with initial proposals for market reform, including policies to simplify domestic energy tariffs and force integrated generators, which both generate and supply power, to auction up to 20% of their annual generated volumes. Stefan Bojanowski, project manager of the Review, expands on some of the findings and the proposals on tariff simplification

Why review the market at this time?

The 'Retail Market Review' was announced just two years after the publication of Ofgem's previous major review of the GB retail energy markets in 2008: the 'Energy Supply Probe'.[1] The headline conclusion from the Probe was that there was no evidence of an energy market cartel. On the contrary, many indicators showed that the retail energy markets had made significant progress towards effective competition.

The Probe was, however, far from giving the retail markets a clean bill of health. We found a number of important areas where the transition to effective competition would need to be accelerated. The Probe recommended five actions to do this. Most had two common themes: to encourage suppliers to treat consumers fairly at each stage in the acquisition process (from marketing through to sales, switching and post-sales); and to improve the quality and accessibility of the information available to consumers so that they can make well-informed decisions about their energy supply, and to empower more consumers to engage effectively in the market.

Over the following year these actions were translated into a broad package of new and amended licence conditions. In addition, we introduced a set of overarching standards of conduct that made recommendations on how suppliers should interact and communicate with their customers. At the time we made it clear that, although the standards were not enforceable, performance against them would inform future policy developments.

During and after this transitional period, Ofgem continued its efforts to monitor the retail markets. In addition to our in-house monitoring efforts, we continued the quarterly reporting of our estimates of industry average margins on energy supply. In July 2010, we also published a report reviewing the impact of standard licence condition (SLC) 25A on the prohibition of undue discrimination, and SLC 27.2A on the requirement of cost-reflectivity between payment methods.

The information we gathered across our monitoring activities prompted us to launch a number of investigations and informal reviews of suppliers' compliance with licence conditions in 2010.

- In April and July, we initiated five reviews of compliance with SLC 25A on the prohibition of undue discrimination.
- In July, we launched a formal investigation into the handling of customer complaints by the Big 6 suppliers.
- In September, we initiated the mis-selling investigation with four of the Big 6 suppliers on their compliance with new licence obligations on telephone and face-to-face sales activities.

We were disappointed by the need for these actions—in part, because they showed that, in many cases, suppliers were not acting in the spirit of the new licence conditions. In the worst cases they suggested that suppliers' practices could be in breach of licence conditions and leading to detrimental outcomes for their customers—a simply unacceptable state of affairs.

There were also signs that competition among suppliers was becoming less intense. Our estimate of the margin earned by suppliers on a typical dual-fuel customer increased to £90 in November 2010, a rise of 38% over the previous three-month period. We also observed that the range from highest to lowest prices of standard dual-fuel tariffs offered by suppliers had decreased to historically low levels.

On November 26th, we announced a fast, four-month review of the retail energy markets. This was our signal to the industry that their efforts to protect the interests of consumers might still be wanting. We wanted to understand more about how and why.

What did the Review find?

The Review built on the analysis undertaken in the 2008 Probe. Our objective was not to repeat the Probe, but rather to update it. We wanted to understand quickly which areas of the market had improved and which still showed signs of concern. We then wanted to delve into these specific areas to better understand their causes and what could be done to deal with them.

The Review found little evidence that effective competition in the retail energy markets had increased. We used a range of indicators to gauge the level of competition in these markets. These included margins on energy supply; regional and national market concentrations; changes in cost efficiencies; the level of service qualities; evidence of coordinated effects; and the range of products available.

The findings of the Review also highlighted further evidence of poor supplier conduct, and concreted our belief that their reaction to the post-Probe remedies had been lacklustre.

It may come as no surprise that our Consumer First[2] panel research showed that many consumers still have a broad mistrust of suppliers. Consumers felt that the least credible sources of information on the energy market were those emanating from suppliers, including their websites, advertising, literature and supplier sales calls.

The Review found a large amount of evidence relating to tariff complexity. We found that the total number of available domestic tariffs had increased by over 70% in two years (see Figure 1), and, through conversations with consumers, we found that many were calling for significant improvements in simplicity. In particular, we found consumers calling for:

- more immediately accessible tariffs, ideally offering directly comparable unit prices;
- greater predictability and reliability of prices and offers. A 'fair' system would give consumers greater confidence in difficult economic times;
- transparency—'choice' is not a bad thing—rather, there needs to be transparency in the choices available such that the power of choice can be harnessed by consumers with different levels of sophistication and knowledge.[3]

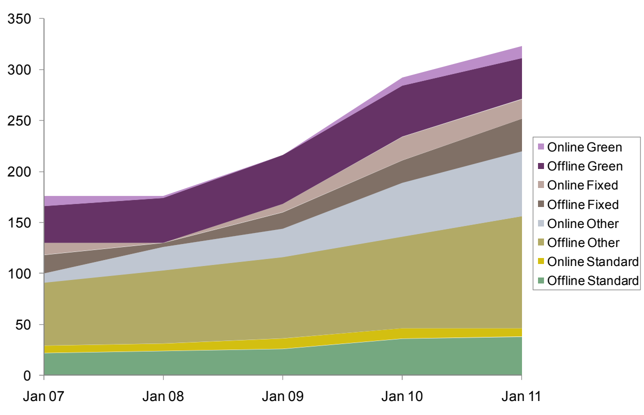
Our own research on tariff complexity was supported by research carried out by the UK Office of Fair Trading (OFT). Its 2010 'Advertising of Prices' study indicated that, of the nearly 1,000 people surveyed, more people had experienced some form of complex pricing for gas or electricity supply than in any one of the 15 sectors investigated as part of its review.[4] The prevalence of complex tariffs in the electricity and gas markets may help to explain why over a quarter of gas and electricity customers surveyed in January 2011 could not say whether they had saved money after switching supplier during 2010. This had increased from around 15% in 2008.[5]

We also confirmed our Probe findings that a very large number of customers remain persistently or permanently disengaged. Our consumer switching survey showed that only 40% of consumers report *ever* having switched, leaving some 60% persistently disengaged.

This is not necessarily bad news. The same survey showed that, when asked why a consumer had not switched, 77% report that it is because they are happy with their current supplier. More worrying, however, were findings from our Consumer First panel research suggesting that many consumers think that their supplier has put them on the best deal. This is likely to skew customers' perceptions of the benevolence of their suppliers.

Overall, the Review painted a picture of a market that had edged backwards rather than forwards since the time of the Probe. The notion that competition was effectively protecting the needs of consumers was absent from our conclusions. As at the time of the Probe, there was sufficient evidence for new and

Figure 1 Number of tariffs available to domestic consumers on January 1st, 2007 to 2011



Source: Ofgem analysis on data from TheEnergyShop.com.

enhanced policies to tackle a range of market concerns.

We put forward five proposals for reform in the Review. These included proposals to enhance wholesale market liquidity, strengthen both non-domestic and domestic license conditions, and improve tariff comparability. The final section of this article focuses on the last proposal.

Why improve tariff comparability?

In addition to the quantitative and qualitative findings detailed above on the prevalence and effects of complex pricing, we looked at the theories of behavioural economics. We wanted to understand more about how certain biases in consumer behaviour could be exploited by energy supply companies. Our findings were detailed in a paper accompanying the Review,[6] which suggested four main consumer biases that GB energy suppliers could exploit, as detailed below.

Limited capacity

Limited capacity refers to consumers' difficulties in assessing large amounts of information about competing offers. While switching sites and face-to-face sales agents provide a bridge for many consumers to engage with the energy markets, our consumer research tells us that only 16% of customers in 2010 used switching sites for their last switch.[7] Furthermore, customers still regard information provided by suppliers as some of the least credible. This suggests that the tools available to consumers to improve their access to the energy markets are not as effective as they should be.

Suppliers (of any product) can exploit consumers' limited capacity by creating excessively complex products. This reduces the ease of product comparisons, thereby complicating the switching process for consumers. This may lead to lower or less effective consumer engagement, such as switching decisions that lose a consumer money.

Status quo bias

Status quo bias is the preference of many consumers not to change their existing situation. Our 2010 consumer research survey showed that 89% of consumers questioned were aware that they could switch energy supplier, yet only approximately 40% had ever switched.[8]

Unlike many products or services, status quo bias is amplified in the energy sector due to the high incidence of evergreen contracts (contracts with no renewal or end date). Datasets of the UK Department of Energy and Climate Change suggest that some 75% of all electricity and gas consumers in GB are on this type of contract.[9] Without a natural 'trigger point', many consumers are seldom presented with the need to reconsider what they are paying for their energy.

Loss aversion

Loss aversion is the preference of consumers to avoid a loss rather than make a gain. It results in many consumers being risk-averse in their decision-making, and manifests itself in the GB energy markets through the abnormally high estimates that consumers place on the savings required to induce them to switch. Survey work, undertaken in 2008, showed that the mean, calculated, annual saving that dual-fuel consumers would need in order to switch supplier was as high as £390.[10] This compares with a maximum annual saving available for 2010 of £256.[11] Gains from switching are even lower if a customer is already on a supplier's (often cheap) dual-fuel deal.

These savings estimates are also likely to be biased by a lack of understanding of the switching process itself and by consumers' perceptions of the complexity of the market (limited capacity). This means that in the absence of loss aversion, consumers tend to overestimate the complexity of switching and require a higher gain from switching than the actual time commitment would suggest.

Time inconsistency

Time inconsistency skews the preference of consumers for returns today above returns in the future. Similarly, it skews the preference to delay a payment into the future, even if this results in a significantly higher charge.

Companies exploit time inconsistency by using short-term, introductory discounts to deliver immediate gains to consumers from switching. However, time inconsistency may also reduce consumers' desire to invest time in the switching process, particularly if the resulting savings are spread over many months.

These biases are not unique to energy consumers, nor are the efforts by suppliers in other sectors to exploit them. Such efforts result in lower comparability of different offers among suppliers and, in some cases, in loss-making switching decisions by consumers.

How to improve tariff comparability

Our tariff proposal is principally aimed at increasing consumer engagement by improving tariff comparability and reducing tariff complexity. The Review's consultation presents a straw-man option to do this. Its basic features are as follows.

- Suppliers are limited to just three evergreen tariffs (one for each major payment method). These

Table 1 Objectives, concerns and mitigating measures

Proposal	Objective	Criticism	Mitigation
Designated format for evergreen products	Increases comparability between evergreen products	Leads to two-tier market	Suppliers to present all prices using an 'evergreen-equivalent' metric
One standard product permitted per payment method	Increases simplicity to reduce poor switching decisions	Stifles innovation. Impairs the smart meter roll-out	Complete freedom to offer a range of non-standard offers will maintain innovation

Source: Ofgem.

standard tariffs would be designed to follow a structure mandated by Ofgem, which would allow consumers to compare evergreen tariffs across suppliers and payment types using a single unit rate.

- Suppliers are still able to offer an unrestricted number of non-standard tariffs, provided that these are for a set duration with fixed terms and conditions. No unilateral contract variations or automatic roll-overs to another non-standard product without the customer's explicit agreement would be allowed.

Greater consumer engagement does not necessarily mean higher switching rates. For example, an increase in the comparability among tariffs would enable consumers to more readily understand the nature and extent of price differentials among them. This alone would increase the threat of switching by consumers and maintain the pressure on suppliers to keep prices down.

In addition, if there were a greater take-up of non-standard, fixed-term offers, more people would face a timely trigger point to reconsider their energy requirements and possibly switch supplier, or tariff, as a result.

We accept that there is a range of challenges surrounding implementation that will result in costs to both Ofgem and the industry. We will not embark on any path of reform unless we can be confident that the benefits outweigh the costs.

There are, however, two principal criticisms that we have heard relating to our proposal to limit and simplify standard evergreen tariffs. Table 1 above sets out the objectives, criticisms and mitigating measures of the proposal.

The first is that the policy would create a two-tier market for energy, with suppliers competing for active consumers in the non-standard market, while letting the prices of standard products rise. To reduce the chances of this occurring, we would want to employ two mitigating measures. The first would be to mandate suppliers to present all non-standard tariff offerings using an 'evergreen-equivalent' price metric. This would mean that consumers could compare the prices of all tariffs in the marketplace with ease. The second would be to mandate suppliers to present, in a prominent position, an applicable range of low-price, non-standard and standard offers on the annual statements and/or bills of all customers. This would act as a timely reminder to all consumers that a wider range of products is available. It would also act as a useful tool for Ofgem to gauge the difference between standard and non-standard prices.

The second criticism is that, by restricting the number of evergreen contracts, we would stifle competition and possibly impair the roll-out of smart meters. This concern is largely unfounded given that the second major element of this proposal is to create an active market for a diverse range of non-standard products. Furthermore, one of the significant challenges facing the smart meter roll-out is that of engaging consumers with the policy, in terms of both consumers cooperating with installation engineers under very challenging national timeframes, and consumers using their smart meters effectively once installed.

Our tariff proposals are aimed at increasing consumer engagement with the energy market. This should lead to direct benefits to those consumers who choose to switch supplier and an intensification of the competitive pressure on suppliers as the threat of consumer switching increases.

However, and importantly, an increase in consumer engagement with the energy market should lead to greater engagement with the smart meter programme itself. This should facilitate implementation of the programme as well as increasing consumers' understanding and interest in the nature of the benefits that smart meters can bring them.

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[1] Ofgem (2008), 'Energy Supply Probe - Initial Findings Report', October.
[2] Consumer First is a programme launched by Ofgem in 2007 that conducts research into consumer matters.
[3] Opinion Leader (2011), 'Ofgem Consumer First Panel Year 3, Report from Second Set of Workshops', March.
[4] OFT (2010), 'Advertising of Prices Annexe N: Consumer Survey Data Tables', December. The study covers mobile phone packages, media packages, energy supply, financial products, toiletries and healthcare, media products, clothes and fashion, entertainment tickets, electrical goods, home improvements, furnishings, groceries, flights and holidays.
[5] Ipsos MORI (2008), 'Customer Engagement Survey', August.
[6] Ofgem (2011), 'What can Behavioural Economics say about GB Energy Consumers?', March.
[7] Ipsos MORI (2011), 'Customer Engagement with the Energy market – Tracking Survey'.
[8] Ibid.
[9] DECC (2010), 'Energy Trends', pp. 48 and 49. This figure is the simple average of the percentage of GB gas and electricity customers on standard tariffs.
[10] Ipsos MORI (2008), op. cit.
[11] Ofgem (2011), 'The Retail Market Review – Findings and Initial Proposals', March, Ref: 34/11.