INTRODUCTION

The dynamics of regulated markets are changing and becoming more complex. At the same time, demands on regulators are increasing from politicians, investors, operators and the public.

Both of these forces are driving a shift away from regulation based on traditional market economics, to instead place greater emphasis on consumer outcomes.

The new environment may place pressure on the original design of regulation of privatised utility industries which was, in any event, put in place long ago at the time of privatisation. How should regulators visibly protect consumer interests whilst providing reasonable predictability and appropriate margins for investors and operators? These issues were explored at a special roundtable held by European Policy Forum’s Regulatory Best Practice Group on Monday 7 January 2019.

The discussion paper by Charlotte Chase, Policy Analyst at the European Policy Forum, outlines the importance of capturing consumer engagement in all of its forms. Switching has long been one demonstrable measure of market competition but, as the report – *Switching and Its Limits* – sets out, fails to fully capture the complexities of consumer decision making.

If regulators are becoming more active in markets, interventions must be made on the basis of an accurate evaluation of market efficiency. And to ensure that interventions improve market conditions, they should be targeted at only those customers who are unable to engage in the market – the vulnerable.

The Energy market has perhaps been the most significant subject of regulatory interventions to improve market conditions. Professor Martin Cave, Chair of Ofgem, has considered how regulators can best ensure that interventions have the intended outcomes and protect consumers from price discrimination.

Regulation must equally facilitate innovation by keeping markets open to new entrants, being aware of impacts of new entrants in the market and ensuring that market sustainability is upheld. Cathryn Ross, Group Director of Regulatory Affairs at BT, has explored the issues around *Regulating Changing Markets* with particular consideration of the development of automated switching services and their role as platforms.

Lord Currie of Marylebone
Chair, Advertising Standards Authority

March 2019
SWITCHING AND ITS LIMITS

Charlotte Chase, Policy Analyst, European Policy Forum

INTRODUCTION

For customers of utility businesses, the ability to switch supplier is a good thing. This is because competition is a good thing. The ability to choose brings opportunities to meet consumer needs on the one hand and pressure to meet efficiency, price competition and good consumer service on the other.

In recent years the level of switching has become a measurement of the success of market provision of utilities and of the perceived success of a privatised competitive market. The assumption is that the greater the number of switches as a proportion of the customer base the more likely customers are to be effectively served by their providers.

By apparently logical extension, a reduction in the number of switches or a failure to switch is seen as a market and public policy problem potentially requiring Government intervention.

A slowing rate of switching is seen as an indication of market failure. In response to the apparent failure, remedial actions are proposed involving Government, regulator or combined Government and regulator action to secure customer benefits.

There are however rational reasons for consumers choosing not to switch suppliers even when faced with potentially substantial savings. These include service quality, the relationship with their current provider, uncertainty of future service and the time spent having to research alternative deals.¹

When a consumer attaches a high degree of value to even some of these factors, potential cost savings can become irrelevant in the decision to research alternative providers because the sunk and relational costs involved with leaving their current supplier would likely outweigh any financial benefit of switching.²

Low rates of switching are not therefore automatically a sign of market failure; consumers in a privatised market should be equally free to choose not to switch as they are to switch.

² Ibid.
Policymakers and regulators may be focusing on switching when they should instead be looking at customer engagement.

A consumer may be highly engaged with the market without switching suppliers, e.g. by staying with their existing supplier but making sure they are on the cheapest deal, or are getting more services for the same price.

Not many customers switching might be just as much a sign of a competitive market than lots of switching. Firms might be responding to the threat of switching by keeping their offers competitive, thereby removing the reason to switch.

**CHAPTER 1: THE ENERGY MARKET**

This cycle of low rates of consumer switching and action by Government and regulators is most visibly underway in the energy sector. There have been repeated suggestions that customers are paying high prices for electricity and gas supplies from the Big 6 suppliers which other customers can buy for less.

An investigation by the Competition and Markets Authority (CMA) into the UK energy market found that “Average domestic electricity prices rose by around 75% between 2004 and 2014, and average domestic gas prices rose by around 125% in real terms over the same period.”

There have been suggestions that customers who do not switch have ended up paying considerably higher prices than those who do, and that many non-switchers are in some way vulnerable.

In 2010, Ofgem launched the Retail Market Review (RMR) in response to concern that the Big 6 energy companies were not working effectively for customers. The review aimed to find ways to promote customer engagement in the energy market, increasing the number of customers switching and improving competition in response to these concerns.

The RMR made a number of recommendations: a ban on complex tariffs; a limit on the number of tariffs a supplier could offer at any one time to four; simplification of cash discounts. These reforms were implemented in 2014.

Contrary to the intent, however, some customers became worse off than previously following the implementation of the reforms. A number of innovative tariffs and discounts were

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4 Ibid., p.41.
5 Ibid.
withdrawn from the market, and tariffs for low volume users were also removed. This resulted in distortion market and a reduction in competition.

Commentators noted that it was not obviously consistent with competition policy for the regulator to reduce the number of available tariffs for customers. By definition, while the new tariffs may support the requirements of some customers, reducing the number of tariffs to choose from would be less likely to meet the needs of customers than the previous tariff system. A wider range of choices could be more closely geared to the requirements of particular customers.

Dissatisfaction continued and in June 2014 Ofgem referred the issue to the CMA.

The CMA published the provisional remedies of its Energy Market investigation in March 2016. These provisional remedies included the creation of an Ofgem-controlled database to enable competing suppliers to contact customers who have been on a standard variable tariff for 3 years or more to promote switching, as well as implementation of a temporary price cap on prepayment meter tariffs. The provisional remedies also proposed a resetting of the relationship between Ofgem, the then Department for Energy and Climate Change, and the industry to promote clearer decision making making a greater public consultation.

In 14 April 2016, Ofgem announced that it would deprioritise “taking enforcement action against any supplier” that did not comply with the four-tariff rule, that the provisional report by the CMA had shown to be counter-intuitive. Ofgem formally changed the licence conditions to eliminate the four-tariff rule following the publication of the CMA’s full report in June 2016.

The CMA made over 30 recommendations in its final report, published on 24 June 2016, which included that: suppliers must inform Ofgem of those customers who have not switched from a default tariff in 3 years in order to allow rival suppliers to contact these customers and offer a better deal; Ofgem should introduce a transitional price cap on prepayment meter tariffs and demand reform of outdated measuring systems in order to reduce energy costs for customers; suppliers should be forced to publish their prices for microbusiness customers, as well as prevent locking in such customers to expensive ‘rollover’ contracts.

26 out of these 30 recommendations proposed action by Ofgem. Ofgem responded to the CMA’s report in August 2016 and outlined its strategy for implementation. It immediately

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8 Competition and Markets Authority, CMA sets out energy market changes, 10 March 2016, [press release].
published a statutory consultation on the removal of the ‘simpler tariff choices’ rules and the ‘clearer information’ rules. Resulting changes to the licence agreement were published in October 2017.\footnote{N. Barnes, \textit{Modification of the electricity and gas supply licences to allow suppliers to roll customers onto further fixed-term tariffs at the end of their existing fixed-term deals}, 11 October 2017, [letter].}

Arguably the most significant of the CMA’s recommendations was the introduction of a cap on prepayment meter tariffs.

Following the publication of the CMA’s final report, it drew up ‘The Energy Market Investigation (Prepayment Charge Restriction) Order 2016’ in December 2016 which gave Ofgem the power to set a price cap for users of prepayment meters.\footnote{Competition and Markets Authority, \textit{Energy market Investigation, The Energy Market Investigation (Prepayment Charge Restriction) Order 2016}.} This applied to more than 4 million customers on prepayment meters who are often the least able to switch and would reduce their average annual bill by \£75.

The price cap is expected to last until 2020 when the full roll-out of smart meters should be completed and provide more detailed information on a consumer’s usage to inform their tariff selection. The price cap does not apply to those customers with a fully interoperable smart meter already installed which can already offer such benefits.

Ofgem extended then this price cap through the ‘Warm Home Discount’ to a further 1 million vulnerable customers in February 2018.\footnote{Ofgem, \textit{Prepayment price cap (or ‘Safeguard Tariff’)}, 2018.}

In February 2018, the Government introduced proposals to Parliament for a temporary tariff cap on Standard Variable Tariffs and Default Tariffs.\footnote{Ofgem, \textit{Default tariff cap}, 2018.} The Domestic Gas and Electricity (Tariff Cap) Act 2018 was given Royal Assent on 19 July 2018. This will cap tariffs that are considered poor value and protect those customers whom are not engaged with the energy market from market inefficiencies. These measures will protect a total of 11 million energy customers.\footnote{Department for Business, Energy & Industrial Strategy and Ofgem, \textit{Domestic Gas and Electricity (Tariff Cap) Bill}, 26 February 2018.}

More broadly, Ofgem recognised that it needed to move away from a rules-based approach to the market because this was only perpetuating the behaviour of energy companies. Instead, the emphasis should be placed on suppliers to deliver the best outcomes for consumers and Ofgem to take action when this did not happen.\footnote{D. Nolan, \textit{Implementing the Competition & Markets Authority (CMA) remedies}, 3 August 2016, p.3, [letter].}
To engage more customers in the energy market, Ofgem agreed to undertake randomised control trials to test prompts on customer communications.

CHAPTER 2: IS SWITCHING A GOOD MEASURE OF CUSTOMER SATISFACTION?

This sequence of events suggests that the current debate on switching merits closer examination.

It is clear that customers’ decisions to choose particular suppliers are not all about money – or not just about a particular tariff in a particular year – and that there are rational reasons for customers to stay with suppliers who may not come up top on a switching chart.

In 2012, Which? led a ‘Big Switch’ campaign designed to reduce the time and research required to find the cheapest energy tariffs and empowering consumers to switch suppliers.

In an examination of this campaign, a report by the Centre for Competition Policy found that only a quarter of those who opted-in the scheme and were presented with potential savings actually went through with a switch. Furthermore, less than half of people presented with savings of over £300 per year switched suppliers.

A more comprehensive examination of the theory and practice of switching was published in the Journal of Business research in 2002 by academics at the University of Tennessee and the University of Alabama. It identified a number of issues which could restrict the utility of switching.

One category is a lost performance cost by which customers may perceive that benefits and privileges of their existing relationship may be lost by switching and these may include the quality of service, the relationship which has been established with the supplier and the possibility of favourable deals on repurchasing.

A second category concerns uncertainty costs where customers may receive the likelihood of lower performance when switching.

Two theories have been established on consumer behaviour that amplify the influence of perceived loyalty on a consumer’s decision to switch.

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18 Ibid.
The first of these theories is the ‘certainty effect’ which proposes that consumers overvalue uncertain outcomes relative to certain ones when making a rational decision.\textsuperscript{19} When applied to switching suppliers this means that the quality of service received from a consumer’s current provider must be disproportionately low before the benefits of switching provider become significant enough for a consumer to decide to switch.

The ‘reflection effect’ captures the idea that consumers weight potential losses more heavily when making a decision than potential gains.\textsuperscript{20} Making decisions in uncertain conditions relies on the potential to feel regret or satisfaction.\textsuperscript{21} The decision to switch therefore becomes based on a future horizon in which switching is potentially not the best option.\textsuperscript{22}

This disproportionate weighting of uncertain outcomes means that incumbent providers have an advantage over alternative suppliers based on consumer behaviour.\textsuperscript{23} Customer satisfaction with their current provider must be extremely low in order for it to be a rational decision to choose an uncertain outcome.

A third set of issues concerns the cost of search and evaluation ahead of switching – the time and effort of gathering and evaluating information. Here customers may perceive that they have limited alternatives; the service levels are intangible; that there is a low brand awareness, especially of new entrants to the market.

A further issue concerns the post-switching behavioural and cognitive risk costs. Here customers have to invest time and effort into learning a new relationship with a supplier which may affect the way they handle bills, customer service requests, direct debits and so on which may require quite a high level of customer involvement.

Extending this concept are the setup costs of providing new suppliers with detailed customer requirements and other information which may involve cumbersome information gathering procedures.

Finally, there are sunk costs in existing relationships. Customers reasonably perceive that they have made an investment in a particular supplier relationship which, may be valuable in itself as a result of the length of patronage, the familiarity, the matching of needs and a feeling of trust. Even where these attributes are not fully present, there may be real losses arising from a change in relationship.

\textsuperscript{19} Zhu, ‘Searching and Switching Across Markets: Is Consumer ‘Inertia’ the Result of a Mistake or a Preference?’, 2017, p.68.
\textsuperscript{20} Ibid.
\textsuperscript{21} Ibid.
\textsuperscript{22} Ibid.
Forcing customers to switch to the cheapest tariff may not therefore lead to the best outcomes because it can be rational for a consumer to remain with their current supplier even if they are not the cheapest.

A study published on ‘Consumer attitudes towards switching suppliers...’ in 2008 found that “A negative attitude towards switching supplier was shown to increase with loyalty, increase with information search costs and decrease with expected economic benefit.”

Consumer loyalty is closely related to levels of satisfaction. Figure 1 shows that customer satisfaction in 2018 with the UK’s six largest energy suppliers is similar with a range of just 6%. Although such surveys cannot be definitive, such high levels of customer satisfaction may suggest that only the small proportion of consumers who are unsatisfied with their service would consider switching.

Figure 1

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25 Ibid., p.815.
It should, however, be mentioned that measuring consumer satisfaction is inherently subjective and should not be relied upon as the sole mechanism for evaluating the effectiveness of a market.

On this basis, the Centre for Competition Policy suggests that policy makers should lower their expectations for the rate of switching.  

**CHAPTER 3: PROPENSITY TO SWITCH**

The economic benefits remain the greatest factor in a consumer’s decision to switch, yet this only becomes relevant once a person has made the decision to research alternative suppliers. A consumer’s propensity to switch is therefore the most important stage to examine and is clearly more complex than a decision solely based on the potential financial savings that could be realised by switching supplier.

There is a positive correlation between higher income and a consumer’s propensity to switch. Consumers with higher incomes are more likely to be engaged with the market and therefore better understand the process of switching.

A slow rate of switching should not therefore be interpreted as a market failure, but force more careful investigation of all factors in the market including the service quality of the alternative supplier, the sunk costs in the existing supplier and the satisfaction with the current supplier. This will offer a true indication of the effectiveness of the competitive market.

It is undeniable that many customers who could switch and benefit do not do so and pay more than they should do for utilities; however, it is evident that many consumers have made a rational choice not to switch. This should be respected by Government and regulators as a feature of any competitive market.

Forcing customers to change to tariffs which they have not chosen is actually damaging to the process of competition because it reduces the gains from switching and will – other things equal – reduce customer engagement in the market and reduce the effectiveness of competition. This damages all consumers in the market (even if it results in less of a gap between the outcomes for those who have switched and those who have not).

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27 Ibid.
28 Deller et al., ‘Switching Energy Suppliers: It’s Not All About the Money’, p.15.
29 Ibid.
Policy and market interventions should therefore be restricted to those customers who exhibit *irrational* behaviour by *not switching when they are dissatisfied with the service from their supplier*. Customer dissatisfaction could be caused by a number of factors not limited to high and increased cost, poor customer service and poor maintenance of supply infrastructure causing outages.

**CHAPTER 4: INTERMEDIARIES**

There are some new entrants to the energy market that are significantly reducing the threshold of uncertainty by decreasing the research time required to switch suppliers and uncertainty of the new supplier’s service quality by offering an automatic switching service for consumers.

Ofgem published a consultation on changes to the Confidence Code which governs accredited price comparison websites. The CMA recommended that the requirement for price comparison websites to compare the whole of the market should be removed in order to promote the development of innovative price tariffs. Ofgem was cautious in implementing this to the full extent without knowledge of its potential impact on the market so promoted flexibility on how tariffs are displayed on price comparison websites in the first instance.\(^\text{30}\)

The switching industry, which has grown up, has its own interests which need to be factored into account, including that price comparison websites are typically financed by fees paid by the gaining supplier after a customer switch decision.\(^\text{31}\)

In its investigation into price comparison websites in 2017, the CMA found that “90% of the people we surveyed were very or fairly satisfied with the sites they used.”\(^\text{32}\) In those cases, however, where such sites were not working in the best interests of consumers the CMA made five major recommendations which included that sites should be transparent about how they make money.\(^\text{33}\)

The CMA also emphasised that all regulators with a stake in the sector should work together to ensure consumers are protected on this issue.\(^\text{34}\)

Consumers should be aware of the relationship of such services with suppliers, but they equally lower the propensity to switch threshold significantly which could increase the switching rates.


\(^{32}\) Competition and Markets Authority, *CMA steps in to give people a better deal on comparison sites*, 26 September 2017, [press release].

\(^{33}\) Ibid.

\(^{34}\) Ibid.
Automated switching services may offer some advantages. They provide an entrepreneurial, market response to the ‘switching problem’ by offering search and switching services. They essentially deliver the two things that customers are looking for beyond the actual product/service, which is convenience and peace of mind. And they provide a solution to ‘lack of engagement’ that does not involve badgering customers to be more active and engaged than they really wish to be.

Such automatic energy switching services simplify a consumer’s decision to switch as they cannot account for weighting of uncertainty and potential losses. Policymakers and regulators should examine the switching market more closely in all its aspects. Although often portrayed as positive and altruistic it is a market like others with incentives and potential problems. Transparency is important: switchers may be unaware of the nature and scale of the rewards received by switch sites from suppliers.

Flipper, for example, is funded through users paying a subscription fee to the service, rather than by the suppliers being switched to. Flipper charges users £25 per year and will only switch a customer to a new supplier if they can make a saving of £50 or more.

Automated switching sites may have incentives to promote churning of customers and there may be other negative effects for example in cold calling, nuisance calls or misleading advice.

Some energy suppliers have attempted to block automated energy switching services claiming poor customer service, a failure to pass on important information to customers and data protection fears. Automated switching companies – Flipper and Swtichd – complained to Ofgem about this obstruction and Ofgem ruled in their favour in May 2018.

A competitive market should not have to sacrifice quality and consumer satisfaction. It is important to keep barriers to entry and expansion in such businesses low to help competition thrive; however, at the same time the barriers for new suppliers entering the market must ensure they have sustainable business models for the long-term.

The whole market pays the costs of a supplier collapsing. This has been seen repeatedly in the energy sector, for example Extra Energy collapsed in November 2018 affecting almost 130,000 customers. In response, Ofgem announced rules to be implemented by Spring 2019 that will force companies to demonstrate that they have adequate financial resource and can meet their obligations to consumers as part of awarding their license to operate.

More stringent rules on entry to a market will mean that the barriers to entry for new automated switching services, price comparison websites and other innovative tools to help
consumers engage, can remain low. This will offer the greatest chance for this technology to evolve without promoting suppliers with unsustainable business models.

Open data offers one means to promote new entrants into the intermediaries market. The financial services industry has demonstrated the benefits of open data under the PSD2 (Second Payment Services Directive) legislation that has afforded new companies, in particular Fintech organisations, access to data from across multinational incumbents, breaking their monopoly on the markets. The legislation aims to create a level playing field for new-entrants and incumbents alike to promote competition in a way that will deliver the best possible service for customers.

Similarly, regulators should consider the benefits of enforcing open protocol software. This will give automated switching sites access to the code that suppliers use to determine consumer tariffs. Closed protocols make it very difficult for software engineers to operate across different platforms, restricting the ability to compare suppliers’ prices. Open protocols would therefore increase the pace of development and possible benefits for consumers of price comparison websites and automated switching services.

Service providers themselves may need to be more active in designing switching models with which they can work perhaps along the lines of the model which has developed for switching bank current accounts. Such developments mean that one person’s market failure can be another’s business opportunity and that not every ‘problem’ in a market necessitates heavy regulatory intervention.

Both automated switching sites and price comparison websites provide the tools for consumers to engage in a market more easily; their uptake will depend on a consumer’s willingness to engage in the market.

Price comparison websites do require greater investment of time and knowledge on the part of the consumer but will arguably lead to better results as the consumer can consider the range of factors that determine their decision to switch, rather than treating switching as a binary choice based on price. Automated services will likely appeal most to those consumers who know that they should switch but do not think that they have the time to do so; consumers who do know that they should switch will still be unlikely to engage in the market.

Equally, automated switching sites may provide a gateway for consumer engagement: once a customer has seen that switching can save them money and perhaps even better customer service, they may be more inclined to switch themselves in the future. Automated switching
services are certainly not the pinnacle of consumer engagement, but are a step in the right direction.

CHAPTER 5: THE FUTURE REGULATORY APPROACH

Regulators are facing new pressures to focus on whether companies are delivering from the perspective of consumers, as well as whether markets are competitive according to economic models. Furthermore, new tools for consumer engagement, innovative business models based on new technologies and concerns over data use all play a role in the market.

A two-fold approach is therefore required to ensure that markets are no longer inaccurately judged solely on how many customers are switching suppliers.

First, understanding of the limits of switching must be accompanied by realistic assessment of customer engagement and means to increase it. This report has demonstrated that consumers do not base their decision to engage with the market solely on potential savings to be realised; time pressures, knowledge, sunk costs, reputation and more all factor. It must be accepted that a consumer choosing not to switch can be a demonstration of engagement in the market as much as a consumer that does decide to switch.

Intra-company switching also needs to be taken into account. A consumer may value the reputation of their current energy company so much so that they do not want to switch to another provider, but they may be able to move to a better tariff within that same company. This is an equivalent demonstration of consumer engagement.

Of course, tightening the barrier to entry for new suppliers will make loyalty less of a factor in a consumer’s decision to switch.

Secondly, regulators must explore non-interventionist techniques that can be used to improve transparency and clarity for customers around their right to switch.

Ofcom has launched a campaign – Boost Your Broadband – to better inform customers about what broadband speeds are available to them, what their usage requirements are, and how to find the best deal on their broadband. Making it as easy as possibly for consumers to make their own decision on whether to switch is the right thing to do and will promote the best market conditions.

Ofcom also introduced new rules in December 2018 that broadband, mobile, landline and pay-TV providers must alert customers about the best deal or ‘tariff’ they can offer when a
customer’s current deal is coming to an end. Suppliers must also do this for every longstanding customer that has stayed with them.

These ‘nudges’ should help to trigger consumers to consider whether they want to switch and provide them with the tools and information necessary to do so.

The difference in prices paid by new customers and existing customers for the same service is a concern when consumers are not engaging in the market. This price differential is an inherent product of competitive markets in which suppliers are trying to attract new customers by offering the best deal.

The Financial Conduct Authority (FCA) outlined its concerns and potential remedies for the financial services market in its discussion paper published in October 2018 – *Fair Pricing in Financial Services*. Two practices were detailed to be of concern for the regulator when they lead to bad outcomes for consumers:

1. Price Discrimination: charging different customers different prices for the same products/services based solely on their sensitivity to price;
2. Loyalty Pricing: charging existing customers higher prices than new customers.

Ofcom announced in December 2018 that it would launch a review into broadband pricing due to concern that some customers were paying more than others for similar services. The review will examine how companies’ prices change over time and which customers are most affected by this.

Assessing whether the price differential is justified becomes more difficult the more diversified the market is. The question is how and to what degree regulators should intervene to address this price differential.

On the issue of how regulators should address unfair treatment of consumers, the FCA discussion paper raises several possible ways to address harm caused to consumers:

1. Make consumers aware of loyalty pricing;
2. Disclose information of tariffs and contracts;
3. Share data to support intermediaries;
4. Make longer-term contracts compulsory to reduce the costs of shopping around;

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36 Ibid.
5. Remove auto-renewal of contracts by default;

Many of these policy interventions apply to other markets as well as financial services. A novel way of ensuring that customers have sufficient information to switch is the policy once used in Hungary: a nationwide insurance renewal period for one week of the year to shorten the window in which consumers had to engage in the market. A specific period of the year was determined whereby all consumers would have the opportunity to switch (contract end dates were aligned on this basis). A national campaign would take place, focussing attention and informing consumers on the benefits of engaging in the market.\(^{37}\)

In attempting to address instances where outcomes for a particular group of consumers are deemed to be unfair, be that through price discrimination or loyalty pricing, it can leave another group of customers less well off.

Policy interventions, such as the limitation of available tariffs imposed by Ofgem in the energy market described earlier, will not always be beneficial all consumers in the market.

Having recognised that there are limits to switching, remaining consumers not able to effectively engage with the market should be considered vulnerable.

The FCA suggests that there are four factors which could contribute to a consumer’s vulnerability: health, resilience, life events and capability.\(^{38}\) In any of these cases, there may be specific reasons which prevent a consumer engaging in the market, leaving them vulnerable to detriment.

Vulnerable consumers will be a relatively small percentage of the market based on this definition. Defining and tailoring the least intrusive remedies to counter harm to this group will be the next challenge for regulators.


\(^{38}\) Ibid., p.20.
SWITCHING AND OTHER REMEDIES IN RETAIL ENERGY MARKETS

Professor Martin Cave, Chair, Ofgem

WHEN IS SWITCHING A POSITIVE SIGN?

The process of switching suppliers is – rightly or wrongly - viewed a costly exercise by many people, both before, during and afterwards. And ways of avoiding the imposition of switching on people who find it costly should be embraced - unless not switching is even worse. The importance of this goal declines, of course, if measures are simultaneously taken to make switching easier and more palatable.

Put differently, ‘shopping around’ is not a benefit but a transaction cost. (I acknowledge that here I am implicitly excluding – perhaps for obvious reasons in the case of energy – the possibility of ‘recreational shopping’.) And such costs should be avoided, both for standard micro-economic reasons, but also more grandly as comprising, in the form of lack of clarity on legal rights and obligations and high levels of mistrust, an obstacle to economic growth and development.  

To illustrate this reasoning consider a (possibly somewhat fanciful) market which well-informed repeat-purchasing customers rightly suppose to be universally characterised by ‘quality-adjusted everyday low prices’. Here the quality adjustment is important, bearing in mind that the quality and persistence of service even in apparently homogeneous essential product markets can vary a lot across companies and over time.

In such a market, switching occurs when consumers want to try something new, or choose to dual source, or their tastes changes, or they desire to punish a supplier for poor performance, or for other possible specific reasons. If these arise infrequently, switching is infrequent and hence imposes low costs, but the market is still well functioning.

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40 The point has also been made that digital comparison tools which focus wholly on price comparisons can be both part of the solution and part of the problem of making optimal choices, as the inappropriate salience given to price, as compared to quality of service, may lead to errors of judgement. See Amelia Fletcher, Disclosure and other tools for enhancing consumer engagement, forthcoming 2019.
That is the utopian vision. What about the dystopian one? A good starting point is the CMA’s response to the CAB’s super-complaint on the loyalty penalty, covering two telecommunications and three financial services.\(^41\) This concludes (at page 5):

“Overall, we have found that the loyalty penalty is significant and impacts many people, including those who can least afford it. Customers rightly feel ripped off, let down and frustrated. They should not have to be constantly ‘on guard’ or spend hours negotiating to get a good deal. This erodes people’s trust in markets and the system as a whole.”

In the broadband market, for example, it estimated a loss of £1billion per year, based on a £112 pa. difference between average spend per customer for ‘in contract’ and ‘out of contract’ customers, and number of customers ‘out of contract’ (p. 52).\(^42\)

The signal and source of this outcome is price discrimination. Its presence eliminates or reduces the beneficial externality which searchers can confer on non-searchers. When I buy petrol, if I believe correctly that enough other motorists are dutifully searching, I can rely on them to discipline all suppliers’ pricing. But absent of this external protection, non-switching loyal customers are often rolled-over onto high tariffs which are subsequently ‘walked’ as fast as the capturing supplier dares.

Why was energy excluded from the CAB Complaint? I conjecture that it was because the Parliament-imposed default price cap was due to be put in place from January 1 2019. Before then, several hundreds of pounds separated competitive tariffs from the standard variable tariffs imposed by the main suppliers on their non-engaging customers – who were disproportionately composed of disadvantaged groups.

The pricing practices the CMA has identified, including the fact that customer loyalty attracts a premium rather than a bonus, has elicited predictable and widespread criticism of the firms concerned. As the CMA notes, this sows distrust and may also carry wider dangers: to quote Mark Carney, “Just as any revolution eats its children, unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself.”\(^43\)


\(^42\) By way of a crude scale comparison, the CMA in 2016 estimated that the average annual household consumer detriment arising from excessive Standard Variable Tariffs prices averaged over 2012 -5, of £1.6 bn. And Ofgem has estimated that the benefit to consumers of the recently introduced household energy price cap could be up to £1 bn. per year.

\(^43\) Quoted by Roger Cohen, *NY Times*, 29 May, 2014.
Nor has the limit of price discrimination been anyway near reached. The price discrimination underlying the loyalty penalty is quite simple. Victims identify themselves by the persistence of their custom. But this is just the tip of the iceberg.

Thus the supplier of any service will be able to purchase a whole swathe of granular information about any identifiable customer from that customer’s social media site or elsewhere, and use it to personalise its prices in a much more thorough-going fashion. The process is only limited by the (probably diminishing) extent of anonymous purchasing. Not even switching would avail you much in these circumstances, since all suppliers may have the same information and be using similar pricing algorithms.

We do not yet inhabit such a dystopia, and with current limited price discrimination technology, reluctant switching remains for some customers a way of incurring a cost to avoid a greater detriment. It is not the only way, of course, and I return to the necessity and scope of supply-side measures below.

HOW TO ENCOURAGE SWITCHING

Ofgem is currently considering the future of the retail energy supply market, in a way which takes account of the digital transformation of the energy sector and the innovation possibilities it creates, and leads to the consideration of appropriate regulatory responses. The unfolding of these changes may lead to major structural and behavioural changes in the retailing of energy to households and small businesses. For example, the provision of energy used by households might be accomplished via a business-to-business transaction. The firm purchasing the energy might then use it to sell a final retail service such as the provision of transport services by an electric vehicle or a home warmed to a specified temperature. But rather than speculate about these longer term changes, I confine my brief remarks on three more immediately relevant ways of furthering switching: nudging, open data and switching platforms.

A. NUDGING:

Much effort has been expended on furthering analysis and on various randomised control trials, by a number of regulators including the FCA and Ofgem. A recent review seeks to draw

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lessons from this work. It proposes now focussing on customer diversity and vulnerability, and on personalisation of offers permitted by digitalisation.

To illustrate some of this work, I describe two completed Ofgem trials. The first is known as the cheaper market offer letter (CMOL) trial. About 140,000 trial participants – non-switchers on the standard variable tariff, were divided into three groups: one received no communication; the second and third groups received a letter, from Ofgem or another supplier, describing three competing and cheaper tariffs. Against a baseline of 1% switching in the control group, 2.4% of customers who received an Ofgem-branded letter switched, as did 3.4% of customers who received a supplier-branded letter. The average saving was £216.

The second is a ‘collective switch’ trial. About 50,000 non-switchers were offered a chance to join a collective switch, to be orchestrated by Ofgem’s agent in this project, Energyhelpline. 22.4% of trial participants switched their energy deal, compared with 2.6% in the control group. Almost a quarter of those who chose to switch via Energyhelpline were over 75 years of age. Phone switching was more popular than online. Customers saved an average of around £300 a year.

A question which arises from such trials is: how can we make an aggregate determination of their likely effects over time?

- are some customers susceptible to one approach, and others to another?
- do some modes favour vulnerable customers in particular?
- do successive exposures to the same stimulus weaken or strengthen the propensity to engage?
- how acute is the problem of recidivism (reversion to former higher tariff levels)?
- how scalable are the trials?

The two trials discussed above have the advantages and disadvantages of using ‘analogue’ technologies – letters, phone calls and text messages. The next one is in many ways a ‘digital’ step-up.

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45 FCA/CMA, Helping people get a better deal, October 2018
B. OPEN ENERGY:

Letters and telephone calls are an expensive way of transacting, but they may be essential for some classes of consumer. For others, they can be replaced by granting third parties access to customers’ data (with their consent).

This may involve use of application programming interfaces or APIs. These connect the core software provided by an incumbent to application software provided by 3rd parties. The interface can remain closed or be open - in which case 3rd parties can transfer data and use the functionality of the platform.

The best known ‘regulatory’ use of APIs in the UK is Open Banking, in operation since the start of 2018. In energy, a Government programme known as Midata began some years ago, but now has new impetus. In 2016, the CMA recommended implementation of a revised Midata programme to ensure domestic customers can access their data electronically – to promote engagement and enable easier switching. Ofgem is leading a new cross-government team to take forward the recommendations from a July 2018 Government decision.

The concept is now similar to Open Banking, though some technical solutions may differ to reflect the energy market context. Ofgem will use its powers to place obligations on suppliers to implement a common data standard, by the end of 2019. That data standard is currently under development with industry, and is capable of evolving to support the development of innovative data-driven services. Other countries with near universal smart meters, such as Norway, are advanced in this area. Interestingly, the Federation of Small Businesses in the UK has published a consultants’ report on the benefits of this approach in its sector. This is an important development since micro-businesses have been shown to face very high charges and their tariffs are excluded from price controls.

C. AGENCY AND DELEGATION:

One possible type of entrant into the household and small business energy supply market is a particular form of intermediary, a platform to which the customer delegates the choice of supplier, possibly after specifying her general preferences. The platform interposes itself between customers and suppliers, just as Uber regards itself as an intermediary between ride customers and ride suppliers. Many such energy platforms exist already. The customer pays

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48 Fingleton Associates, Open Energy: Using Data to create a smarter, cheaper and fairer energy market, FSB September 2018.
them to choose a supplier either for a fixed period or constantly be checking whether a within-
contract switch should be undertaken.

It can be a concern in such cases that the platform will acquire market power. In the worst
case, the market for intermediary service might tip into a monopoly – the platform then
possibly extracting surplus from both consumers and suppliers.

The risk of this occurrence in the case of a two-sided platform is generally assumed to depend
upon a number of factors, including:

- whether the switching service provided is homogeneous – approximately true in the
case of energy platforms;
- whether the two sides linked by the intermediary use several such platforms at once
(‘multihome’). Probably true of energy suppliers but not of customers: this gives the
platform a motive to attract customers and sell them on expensively to suppliers;
- whether there are indirect network economies, such that customers in particular
favour a platform with access to more providers; this outcome could be prevented by
appropriate obligations on suppliers to deal fairly with any platform.

At present, a relatively small number of customers entrust their business to such
intermediaries. But it is easy to see that there are circumstances in which, with further entry
or otherwise, this could change, and such agency might even become pervasive.

AN IMPORTANT TAIL PIECE IN THE ENERGY PRICE CAP LAW

One problem is that many of these methods require a level of engagement in purchasing or
delegation decisions which not every household or small business will exhibit. In particular,
disadvantaged or vulnerable customers may lack the means to make the necessary choices.
This circumstance was allowed for in the 2018 Act of Parliament which required Ofgem to
impose the default price cap on household energy prices which came into effect on January 1
2019. That price cap may not extend beyond 2023, and may be removed at the end of 2020,
2021, or 2022 at the decision of the Secretary of State, who will have received a
recommendation from Ofgem.

Before the cap is removed, Ofgem must review energy pricing practices and consider if there
are categories of consumers who are paying, or risk paying in the future, excessive charges
for default tariffs, and who need protection. It must also consider whether vulnerable
consumers are in need of protection. Ofgem must do further reviews as appropriate. If the
review concludes that the protections are needed, Ofgem must take action, using its powers as set out under the Gas Act 1986 and the Electricity Act 1989.

I don’t think anyone today can be sure how things will develop. In particular, I cannot be confident that when the current default cap ceases to apply, switching and other remedies will have gone so far that no further protection will be needed – especially for vulnerable customers. The law (and the Board of Ofgem) will not permit a return to a retail market where customers who find it difficult to engage are left behind and exploited.

CONCLUSIONS

In a well functioning market with everyday low prices, switching would be undertaken not to avoid exploitation, but to derive an additional benefit for the consumer. It has become apparent that customers in many markets are subject to substantial detriment from pricing abuse. These include markets for essential services where vulnerable customers may be particularly at risk. This is a crucial aspect of energy markets, which has a profound impact on Ofgem’s approach to these matters.

Ofgem is now set on an approach to protecting household and small business customers which has several elements:

- providing support to engage as many consumers as possible through the use of ‘smart data,’ intermediaries, and switching trials; simultaneously improving and speeding up switching processes;
- implementing the present household price caps until they are withdrawn or new (probably more sharply focussed) ones are installed; these will likely be required to protect vulnerable customers;
- maintaining and strengthening its enforcement actions against suppliers over quality and other service breaches which let their customers down;
- continuing to work on future market design in order to promote further innovation and ensure that the retail market will not return to a situation where customers who find it hard to engage are left behind and exploited.
INTRODUCTION

This is a hugely important topic – it goes to the heart of whether consumers are well-served by liberalised, competitive markets and the institutions put in place to ensure that these markets and the private providers who operate within them act in the public interest. So this discussion is very much central to the current debate about the sort of economy and society we want to be.

Consumer engagement should be the focus of regulators rather than switching. This case has been made in the paper – *Switching and Its Limits*. The distinction between engagement and switching is an important one, even if engagement proves harder to measure.

WHY ARE WE BOTHERED ABOUT ENGAGEMENT?

Consumer engagement has two types of effects on markets:

1. **Static effects** – consumer engagement determines distributional impacts not only in respect of vulnerable customers but also for those in-between. The debate on the loyalty penalty between those who could have engaged and those who didn’t has demonstrated this effect. Markets probably ought to be more concerned about the negative impacts where those impacts have bigger consequences for those affected, i.e. where the ‘loyalty penalty’ accounts for a higher proportion of household income, for example, because household income is low and/or where the service consumed is expensive and non-discretionary.

2. **Dynamic effects** – an effective demand side is vital for effective markets to achieve efficiencies that create value, drive productivity and enable growth.

While a lot of the debate in public policy circles is presently being driven by the former – quite understandably – it is important not to lose sight of the latter.

And if the industry does care about the latter, it suggests regulators should have a preference, wherever possible, for remedies that try to improve engagement and make markets work better, rather than treating the distributional symptoms of lack of engagement.
HOW SHOULD WE IMPROVE ENGAGEMENT?

The shift to an approach based on consumer engagement rather than switching is welcomed here and is more grounded in realism.

There are things that can and should be done to reduce the costs of engagement: making sure that customers get accurate, useful and timely information that will prompt them to engage in markets and make a choice. But we also need to recognise that – as Charlotte’s paper notes – it can be perfectly rational for customers to choose not to engage. Time and energy have an opportunity cost – people should be forgiven for wanting to do things with their Saturday afternoon that don’t involve poring over utility tariffs, or even inputting their last year’s bills into a website that will do the poring for them.

So the emergence of a market for the provision of search and switching services feels like a very positive development. Those companies – like Flipper and Switchd – into which you input your information and they commit to switching you automatically onto the best deal for you, are providing things that customers’ hugely value – convenience and peace of mind. This is especially important in that they are providing this service in markets that both matter and in which customers have lost trust, including in their own ability to make the right choices.

Against a backdrop of believing that these players are providing a really useful service for customers and indeed the market generally, there should be an element of caution. In the first instance there should be explicit consideration of how these services might develop.

THE IMPLICATIONS OF A SHIFT IN THE ECONOMICS OF THE VALUE CHAIN

The more consideration of about what these services are and how they work, the more it would be a mistake to think of them simply as a further evolution of existing technology, as say, the next generation of price comparison websites.

Automated switching services have the potential to fundamentally change the economics of those markets they touch. This is because these service providers have the potential to disintermediate between the companies who provide the services customers want and the ultimate customer. They are not simply helping the customer to make a more informed choice of energy supplier, or telecoms supplier or insurer, they are creating platforms that connect the customer to all that stuff they know is really important, but which is also a bit dull and difficult to deal with.
Perhaps one of the best known examples of a platform is Amazon. Amazon creates value by connecting more people with more stuff and by improving the quality of that connection – knowing more about what the customer wants so they get more of it, more tailored to their needs, provided more immediately.

There is a lot to like about this, but there are potential watch outs.

Platforms are about scale: therefore, it should be expected that search and switching providers look for opportunities to provide their services across a wide range of sectors – energy, banking, insurance. Application in telecoms may not be as easy because products are less homogenous.

Platforms are about data. The more they know about the consumer the better they can connect them with stuff that meets their needs. This gives platforms the potential to take price discrimination to the next level – to create genuinely personalised pricing. Personalised pricing can be achieved today, for example by insurance providers; however, it could become even much more sophisticated if undertaken over a wider bundle of services.

Moreover, the data that the platforms collect is useful and valued beyond their own services. It is very plausible that a customer’s data could eventually reveal them to be more valuable say for upselling insurance or other value added products, so that they get basic utility services for free.

It is also very possible that the kind of platforms that provide these search and switching services will partner with other platforms, like Amazon and Google, who are in the personal data collection and value extraction business.

Platforms might also become the gateways into whole eco-systems of other services – similar to Apple today. In such a world, switching to a different platform may become very difficult, affording platforms a degree of market power.

**THE FUTURE REGULATORY APPROACH**

Despite the potential negatives of platforms that have been outlined, these services should not – at least not yet – be regulated. Imposing regulation now would probably be a great way, if not to kill them off, then at least to stifle valuable innovation.

One of the lessons regulators and policy makers should, though, have learned over the last few years is the importance of thinking ahead. Regulation should be utilised as a framework that helps sectors to navigate through changes and challenges while maintaining legitimacy. This necessitates regulators having an understanding of new business models, how market
dynamics are evolving, and crucially whether they are delivering against the expectations of customers and society.

Regulators and policy makers need to apply these lessons to the new services emerging – to monitor the impact they are having and how they are changing the sectors they touch.

This will not prove to be easy, because these intermediaries are not regulated and are not likely to take kindly to regulators asking questions. Understanding these intermediaries will require a cross sector perspective that will take sector-focussed regulators outside their comfort zone. The UK Regulators Network and the Competition and Markets Authority can help here. A cross-sector approach to these market changes is essential.

The other factor essential to successfully regulating through this change will be to not see intermediaries as panaceas for market failures. The services platforms provide will help markets where low levels of engagement are an issue to work more effectively, but they should equally not be expected to deal with all those outcomes considered socially problematic. As Charlotte notes in her paper, automated switching services will not and cannot fix all those distributional effects that are of concern today. They do in fact have the potential to make some issues worse and even create new ones.

New services should be embraced by markets and as regulators seek to foster them, policymakers should not view them as a cure – interventions that create social transfers are still likely to be needed and it is preferable that they are made by those with democratic legitimacy. Even if it may fall to regulators to remind them of this...