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Received 21.10.14 AP.

20 October 2014

Roger Witcomb
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Authority
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Dear Roger

Energy Market Investigation

It is with great pleasure that I am writing to enclose a Submission to the Energy Market Investigation prepared by Professor Catherine Waddams.

The Submission examines the question of an appropriate tariff structure in retail utility markets with particular reference to the changes which have occurred in the energy sector.

I believe that the paper presents an informed and balanced assessment which explores this question in useful detail and adds to understanding of the issues, and the consequences of a reduction in the number of available tariffs.

I hope that the CMA finds this of assistance in its work.

With best wishes.

Graham Mather
Chairman
EPF Regulatory Best Practice Group

Simplifying Tariffs in Regulated Industries
A Submission to the CMA Energy Market Investigation
By Professor Catherine Waddams
For the European Policy Forum
Regulatory Best Practice Group

Background

1. Regulators have recently been increasingly concerned about the number and structure of tariffs being offered by companies in their sector. The energy regulator, Ofgem, had imposed a limit of four tariffs per payment type on each company, and specified that this should take the form of a standing charge[1] and a running rate under its Retail Market Review; the Office of the Rail Regulator has considered these issues[2] as part of its own Retail Market Review; and the financial regulator has encouraged banks to streamline their accounts, leading to the withdrawal of high interest savings deals.[3] . This paper explores the intuition behind these regulatory moves, reviews the contribution of economic analysis, and draws some policy conclusions. The discussion is limited to residential consumers (who of course are the same decision makers in the different aspects of their lives which these markets represent), which is the main sector where tariffs (rather than individually negotiated contracts) operate. But many of the issues may apply to other customers, in particular to small and micro enterprises for whom each purchase is, as for the residential consumer, one of many for which limited time and attention are available.

2. Consumers play an important role in well functioning markets - if consumers do not respond to better offers by taking advantage of them, there is little incentive on companies to make those offers, or for suppliers to try and retain consumers through counter offers, so that prices might rise throughout the market. The Competition and Markets Authority has identified weak consumer response as a potential theory of harm in its current investigation into the energy market. How far do complex tariffs contribute to such weak response, and what are the likely effects of imposing simpler price structures?

3. When asked why they do not change suppliers, consumers often cite confusing tariffs and difficulty in identifying the best deal for them. For this reason Ofgem, who had been concerned for some time about competition in the retail market

[1] The running rate could be zero https://www.ofgem.gov.uk/simpler-clearer-fairer/simpler-choices
[2] Office of the Rail Regulator, Fares and ticketing – information and complexity, June 2012 http://orr.gov.uk/__data/assets/pdf_file/0018/4905/ticket-complexity-report-june-2012.pdf ; and
[3] Hussain, Ali, 2014. 3m savers hit as banks make covert rate cuts. Sunday Times 31st August 2014 http://www.thesundaytimes.co.uk/sto/business/money/treatsaversfairly/article1452409.ece

and had instituted a Retail Market Review to address the issue, restricted the number of tariffs which each company could charge for each payment type to 4. This followed a period of rapidly expanding numbers of tariffs, particularly following the imposition of non discrimination clauses in 2009. These clauses prevented companies from continuing to offer cheaper prices to consumers they were recruiting outside their areas than those charged to consumers in their home area: in the years up to 2008 companies had been making margins of about 10% more on home than out of region consumers. As predicted[4], weaker competition between company offers ensued, and switching rates fell[5]. This was probably a response to the lower gains available, which is the main driver of consumer action[6]. But a confounding factor may have been the increase in the number of tariffs available, since the companies were allowed to introduce temporary tariffs as a marketing device. From a competition perspective it is encouraging that companies continued to compete for some consumers, despite the opportunity offered by the non discrimination clauses to retreat to their own home areas, where they could charge higher prices; but the regulator then became concerned that this proliferation of tariffs was confusing customers and reducing switching.

4. The new understanding of consumers as 'behavioural', is one of the intuitions which lie behind the proposals. In the energy market, for example, analysis of consumer activity in the fifteen years since choice of supplier became available indicates that many households do not switch supplier (regularly, or at all), even though there are substantial gains available, around £350, or 30% of the bill, for those who have never switched supplier and are using 'traditional' payment methods. Some of this 'inertia' can be explained by preference for a particular supplier or payment method or high costs of searching and switching. But there is particular focus on the energy sector because of its rising cost and price (for environmental and security of supply reasons), and the affordability problems which face many low income households. Moreover the fact that delivered energy is by definition the same whoever supplies it (since delivered through the same pipes and wires) highlights the money left 'lying on the table' by inactive consumers. In this sector, too, the suppliers have followed the longer established practice of banks in offering good temporary deals to those who will switch to them, and 'defaulting' consumers onto higher tariffs after the initial deal ends. Such a 'bait and switch' policy is a common marketing practice, and it is often difficult to identify the ongoing cost of, for example, a new phone contract, since the headline price refers to the temporary introductory offer.

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[4] Non-discrimination in the retail energy sector, by Morten Hviid and Catherine Waddams Price, The Economic Journal, 122 (August 2012), F236–F252. Doi: 10.1111/j.1468-0297.2012.02537.x.

[5] Non-discrimination clauses: their effect on GB Retail Energy Prices 2005-2013 (Catherine Waddams Price and Minyan Zhu), forthcoming The Energy Journal, 2015

[6] Consumer Choice and Industrial Policy: a study of UK Energy Markets (Monica Giulietti, Catherine Waddams Price and Mike Waterson), The Economic Journal, 115(506), pp 949–968, October; Consumer behaviour in the British retail electricity market (Miguel Flores and Catherine Waddams Price), CCP research paper 13-10; Searching and Switching: Empirical estimates of consumer behaviour in regulated markets (Catherine Waddams Price, Catherine Webster and Minyan Zhu) December 2013; 2005

Ironically the same is true of membership of the Consumers Association, Which?, despite its campaigns for clearer pricing in other products, and such practices are seen as a normal part of marketing campaigns in non regulated sectors. However in these sensitive regulated sectors they are considered unfair, and regulators intervene to limit or prevent such practices. We discuss below the factors determining consumer demand, supplier response to restrictions on tariffs, fairness, and implications for policy.

Consumer Demand

5. On the demand side the simplification of tariffs may reduce the barriers which consumers perceive, and encourage more activity, particularly among those who were previously reluctant to change because of tariff confusion. However three factors may limit this increase. The first is that while consumers may say that complex tariffs deter them from switching, their removal will have little effect if there are other barriers such as inattention or lack of confidence. Ofgem's own evidence indicates that few consumers volunteer complex tariffs as a factor preventing switching[7], and experimental evince suggests that simplifying tariffs may have limited effect[8]. The second reason is that although prices may fall through fiercer competition, the 'levelling' of prices will mean that there are fewer good deals available, and so fewer gains available from switching. Since the activity of all groups, including the most active, is strongly affected by the gains to be made, consumer switching is likely to be deterred. It is interesting to note that switching rates fell from the time that potential gains fell in response to the non discrimination clauses, except for the period of intense political exposure of the sector in autumn 2013[9]. Thirdly it is not clear in the energy case that reducing the number of choices from around 500 to, say 100 for each consumer (four tariffs over 25 suppliers), is going to increase activity significantly. If it is the number of possible tariffs which deter consumers, more competitors offering additional options would be seen as detrimental.

6. Surveys of consumer behaviour indicate that while consumers may say they are deterred by complex tariffs, their activity is far more likely to be curtailed by lengthier switching time than longer search time[10]. Indeed there is little evidence that shortening search time through simpler tariffs would encourage more switching. However this evidence is from a relatively active group who are able to provide estimates for potential gains and potential search time - those who are not able to do so might be more engaged by simplification. Nevertheless it is

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[7] Stephen Littlechild's evidence to the CMA inquiry, p. 27 https://assets.digital.cabinet-office.gov.uk/media/53f1bcf2e5274a48c1000011/Stephen_Littlechild_-_Promoting_or_restricting_competition_-_response_to_IS_with_cover_note.pdf

[8] see Complexity and Smart Nudges with Inattentive Consumers by Stefania Sitzia, Jiwei Zheng and Daniel Zizzo, Centre for Competition Policy working paper 12-13, 2012.

[9] Department of Energy and Climate Change Quarterly domestic energy switching statistics https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics

[10] Consumer behaviour in the British retail electricity market (Miguel Flores and Catherine Waddams Price), CCP research paper 13-10; Searching and Switching: Empirical estimates of consumer behaviour in regulated markets (Catherine Waddams Price, Catherine Webster and Minyan Zhu) December 2013

important not to underestimate inherent switching barriers. Even among a particularly active group of well informed consumers who opted into a major collective switching auction and invested a considerable amount of time in providing the necessary information, fewer than one third of those offered a positive saving accepted the offer, even though median savings were around 10% of the average bill and the switching process was extremely simple[11].

Supplier response

7. To respond to demand concerns, tariffs may be simplified without considering the likely supply response. If a range of tariffs is offered, which is then restricted, it is clearly unrealistic to expect the companies to retain only their least expensive tariff, given that this will sacrifice all the revenue they have previously collected from other consumers. To the question - "why can't everyone have it this cheaply?" the response is that this may provide insufficient profits for sustaining the businesses and future investment; and that those who get it cheaply on a short term basis may pay more over a longer period. If concerns arise about the level of profits which companies are making, tariff restrictions are an inappropriate tool which carries potentially adverse consequences to address this issue – removing entry barriers so incumbents can be challenged directly by other companies offering cheaper tariffs is preferable.

8. Simple tariffs may themselves be a means to attract consumers, and some newer energy companies have made this their own marketing strategy, with some success. They are not keen to find that their own special offer is now mandated for every supplier in the market.

9. Restricting the number of tariffs has a similar effect to the non discrimination clauses, in the sense that it limits the extent that the companies can separate consumers by charging them different prices. However unlike the non discrimination clauses, where one company's 'strong' market[12] was another's 'weak' market, companies are likely to agree on which types of consumers within each region they would like to charge higher prices to, other things being equal.

10. So it is likely that imposing such restrictions would strengthen competition between the companies rather than, as in the non discrimination clause case, weaken it. This may bring down the average price level in the industry. Moreover while an individual consumer did not have access to the lower prices which its supplier might be charging in other regions, most of the additional tariffs introduced within a region would be ***available*** to all consumers.

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[11] Measuring Consumer Inertia by David Deller, Joo Young Jeon, Graham Loomes, Monica Giulietti, Ana Moniche and Catherine Waddams Price, forthcoming CCP working paper, 2014

[12] Strong (weak) is used in the sense of the consumers to whom a supplier would like to charge higher (lower) prices, if other companies are charging a uniform price to all consumers.

11. Differentiated tariffs can be a valuable tool in several ways. They may reflect costs, for example discounts for prompt payment which are cheaper for the company. In encouraging consumers to act in ways that reduce costs, gains may be available for all. If there are fixed costs to be recovered, the most efficient way of doing so is to charge more to consumers who are less price responsive. In this way demand is disturbed as little as possible from the 'optimum' when prices reflect only the incremental costs of supplying each consumer. One way of approximating the potential benefits of charging consumers separately is to charge different tariffs according to how much is used, with a lower standing charge and higher unit rate for low users, and a lower standing charge and higher running rate for those who use more. This can be efficient in the same way.

12. However the fact that companies may choose different tariffs which are efficient (in the sense of maximising the total benefits to both consumers and providers) does not mean that these are the ones they will choose. Companies operating without restrictions will make higher profits if they exaggerate the differences in price (compared to the efficient outcome), and since it is very difficult to calculate exactly what the right differences should be, this is difficult to control. Banning the price differentiation is one way of preventing such behaviour, though it does have an element of throwing out the baby with the bathwater.

Fairness

13. Fairness is a great concern to policy makers and commentators in markets for essential products. One relevant factor is the extent to which one consumer may gain in one time period, but lose in another[13]. This depends partly on whether they continue to be active, and find another good deal when the temporary 'bait' rate expires. But even if they are not, and pay the higher rate for some time, the relevant net costs or gains are appropriately measured over several time periods, including that in which the lower rate was paid. There are many products and services consumed over time, classically capital equipment and later materials or servicing (for example coffee machines and 'pods', photocopiers and servicing), where both theory and legal judgments have recognised the importance of evaluating the whole package, not merely any 'overpayment' of the ongoing element. Bait and switch offers could be presented as an introductory offer to overcome consumer switching costs, with the company recouping these legitimately in later higher payments. Of course it is not acceptable for prices to be misleading or deceptive; such behaviour is illegal under consumer protection law, and these laws should be enforced if there is concern that they are being violated.

14. While the argument above suggests that those who have switched have at least received some benefits from their initial offer, those who have never switched

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[13] see for example Chapter 31 Coordination and Lock-In: Competition with Switching Costs and Network Effects, by Joseph Farrell and Paul Klemperer, in Handbook of Industrial Organization Volume 3, 2007, Pages 1967–2072

are likely to be on higher tariffs than those who have been active. This is a natural consequence of incentivising people to change suppliers through lower offers – arguably, as suggested above, to overcome natural inertia and 'switching costs'. Indeed consumers are broadly 'rational' in the sense that as a group they are more likely to change suppliers when they expect higher gains from doing so. It is difficult to see how competitive markets could operate without this effect, and an alternative interpretation of fairness might be that those who make the effort to change supplier should reap more rewards.

15. The fairness issue is more pertinent if the ***opportunity*** to switch is not available to all, and this may be particularly relevant for an essential product such as energy, where there is evidence that some consumers may find the process more difficult than others because of their own circumstances. While this issue is beyond the remit of this paper, we note that while those of pensionable age switch less frequently than younger consumers, the age pattern changes when other factors are taken into account. Surveys among representative consumers generally show a U-shaped age curve, with middle aged people switching less often than their older and younger counterparts once other factors, such as the anticipated gain from switching and anticipated time taken to search and switch are taken into account.

16. Fairness concerns from different bills for different consumers (receiving essentially the same service) are particularly salient in industries which are seen as essential to life or social and economic participation. Those whose demand is least responsive to price changes may well be those who are already minimising their use of the product, or for whom lower demand may have adverse health consequences. Regulators and policy makers are sensitive to these concerns (and may have specific social duties) and so find it difficult to tolerate the tariff differentiation which companies themselves may want to introduce.

17. The focus of this discussion has been on the effect on competition in the market through the switching process, since this has been the justification for the introduction of simplified tariffs. The keenest tariffs are likely to be targeted at potential switchers, either for recruitment or retention purposes, so those who have not signaled that they are potential switchers are likely to be both less aware and less eligible for the cheapest prices. Nevertheless the simplification of tariffs will reduce the choice available to this group too, and will adversely affect any who have previously been using tariffs which are withdrawn as a result of such a policy. However if there is keener competition they, in common with consumers in general, are likely to benefit from any consequent reduction in price levels.

18. In terms of winners and losers from tariff simplification, the 'levelling' of prices will mean that switchers are less well off than they previously were, while those who do not switch should see lower prices, depending on how fiercely companies compete with each other. To the extent that non switchers are

predominantly groups who are deemed vulnerable, this will benefit more of them than consumers on average. However these are relative figures, and it is worth noting that though fewer in the vulnerable groups may have switched, within each group a majority may have done so[14]. Thus if the prices for switchers rise, as is likely, a majority of vulnerable consumers may pay more as a result.

19. There are several cases which illustrate the withdrawal of the best offers when companies are restricted in their pricing policy. In the energy sector itself, most of the largest companies have responded to the RMR constraints by maintaining a standard tariff which can be varied (with appropriate notice) as costs change, and two or three tariffs which maintain fixed prices over a pre specified period of one to three years. As noted above, special high interest payments have been withdrawn in banking, which will reduce the potential gains and switching rates. One form of innovation, tailored tariffs for different preferences and needs, are an obvious direct casualty of such regulatory rulings. However simpler tariffs may improve the ***quality*** of decisions, which is also an important motivation for companies to offer better deals[15].

Policy implications

20. Simplification of tariffs is an attractive policy response to complaints that companies are deliberately imposing complex tariffs to confuse consumers, a so-called confusopoly. In energy, this has a high profile antecedent in the promise of the Prime Minister in 2012 that *"energy companies [will] have to give the lowest tariff to their customers."*[16]. Ironically, in energy the complex tariffs were a direct response to another regulatory intervention, the non-discrimination clauses, which forbade differentiation between regions in the standard tariffs, and so companies were allowed, indeed encouraged, by the regulator to offer special deals. In other markets, complex tariffs seem to have developed independently of regulatory intervention.

21. The issues over simpler tariffs, in particular the tension between perceived fairness and the lowest costs and average prices for all consumers, highlights the underlying tension in markets which are seen as particularly important to consumers, often with a history of state ownership and regulation, so that the competitive process is both the 'new kid on the block' and a scapegoat which can be blamed for any adverse changes. If the most important aspect of energy or telecoms prices or bank charges is that everyone should pay the same, even if this is at a higher level, then tariff constraints may be justified. However the question then arises as to whether competition is the best process for such markets, or whether the importance of public confidence and preferences for equality suggest that regulation is a better approach.

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[14] Hviid and Waddams Price 2012, op cit.

[15] though it is discouraging to note that before tariffs became so complex, a significant number of consumers made errors in switching, ending up on more expensive tariffs even when their sole purpose was to save money; Do Consumers Switch to the Best Supplier? (Chris M. Wilson and Catherine Waddams Price), Oxford Economic Papers, 62: 647-668, 2010

[16] Statement to Parliament, 17th October 2012

22. If, however, efficiency, lower costs and innovation are the most important aspects of the market, competition should be allowed to operate with as few restrictions as possible, beyond those which are designed to enhance the competitive process itself (i.e. avoiding market power and its exploitation). Ultimately the decision must be political, and this is probably an area where mixed strategies are likely to result in the worst rather than the best of both worlds. Policy makers need to decide whether they want to pursue competitive strategies, which are distributionally 'blind' and will almost certainly result in some winners and some losers. In this case the policy effort should be to make the market work as well as possible, by encouraging activities which limit market power, and ensuring that consumers have the means of making the best decisions for themselves, which may include use of intermediaries such as brokers or web comparison sites. Distributional objectives should be met using better instruments, such as the tax and benefit system. Restricting tariffs, while it may not have the adverse effects experienced through the non discrimination clauses, will result in lower potential gains for active consumers, which may reduce competitive pressures in the industry. If, on the other hand, sectors such as energy and banking are expected to provide particular distributional outcomes, less piece meal regulation may be a more appropriate framework, despite its well known costs and limitations.

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October 2014