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Dear Anna,

Working paper #3: approach to headroom

Please find our comments on your third working paper on the forthcoming default tariff price cap. This submission is entirely non-confidential and may be published on your website.

The case for including any headroom is weak

We are unconvinced of the need to include headroom in the default tariff cap. We recognise that this would create an inconsistency with the prepayment meter ('PPM') cap, but think that this inconsistency could be justified on policy grounds as there are fundamental differences between the level of competition, and likely spread of prices, between these different parts of the market.

In the case of the PPM market, price spreads prior to the introduction of the price cap were narrow and there was limited incentive to shop around. Because of this, the CMA was persuaded that there was a need for headroom to try and stretch the [price] range of deals on the market, in order to try and ensure that reasonable savings could still be achieved by switchers.

In the case of the standard credit and direct debit market, the starting point is very different. There is a huge price range of deals in the market. While it is likely that large suppliers will narrow their own price range of deals following the introduction of a cap, because it would be more difficult for them to cross subsidise acquisition deals through default tariff revenue, it is unlikely that the overall price floor in the market will be materially dragged up. This is because the best buy tables are dominated by smaller suppliers with few or no default tariff customers. There are now so many of these suppliers, in competition for the minority of actively engaged customers, that similar incentives to undercut incumbent pricing will exist to those that are already in play.

Because the design of the price cap has yet to be completed, there is considerable uncertainty on the level of savings, and possible switching incentives, that may exist. However, if it were similar to the prepayment meter price cap, adjusted for the

lower cost to serve other payment methods, this might imply that if it were in place now, the cap would sit somewhere around £1,030/year at average consumption levels. According to your data, the cheapest deals in the market are around £820/year.¹

Would consumers still switch for just over £200/year? We think that historic data suggests that they would, we explore this later in this letter.

Would the addition of headroom change this? Clearly, by inflating the cap it could increase achievable savings and therefore, in theory, could incrementally increase propensity to switch. But it seems unlikely that a relatively modest amount of headroom - £30/year was used in the case of the prepayment meter cap - would materially heighten switching incentives, because the rough order of magnitude of achievable savings would be very similar both with or without it.

What seems more likely is that the headroom may be used by incumbent suppliers as 'padding' to dampen the revenue hit resulting from the introduction of the price cap. The majority of customers are fundamentally sticky - some 58% have never switched, or only switched once² - and this stickiness reduces the likely incentives on incumbents to price default tariffs materially below the cap. While large suppliers will still need to undercut the cap to gain new customers, they are more likely to do this through dedicated acquisition products rather than through their default tariffs.

In deciding whether to include headroom, we think you would therefore need to determine the trade-off between the beneficiaries of such a move (the minority pool of switchers, who might be able to save slightly more) versus those left worse off by it (the majority pool of sticky customers, who are likely to pay slightly more). We think it is unlikely that this trade-off will be positive.

The impact of price spreads on switching rates

Your consultation suggests that you are seeking evidence and ideas on linkages between price spreads and engagement, in order to understand the merits (or not) of headroom. We think there are a range of evidence sources out there that could help you with this.

BEIS maintains monthly records of switching rates going back to the start of 2003, and we believe that Ofgem has similar subscription access to price comparison website databases to us that could allow it to attempt correlation analysis on the

¹ 'Cheapest tariffs by payment method: Typical domestic dual fuel customer (GB),' Ofgem data portal. Reflecting results shown on 12 April 2018.

² 'State of the energy market 2017,' Ofgem, October 2017. <https://tinyurl.com/y6udhws9>

links between spreads and switching. We include some of our own analysis later in this letter.

Prior to 2003, switching data is harder to come by - our past information requests suggest that neither BEIS nor Ofgem appears to retain any switching data from that period, although it must at one time have been gathered as we have seen references to switching rates in policy documents from that period. The best public record of switching in that era that we can find sits in two National Audit Office reports, 'Giving domestic customers a choice of electricity supplier,' (January 2001)³ and 'Giving customers a choice - the introduction of competition into the domestic gas market,' (May 1999).⁴ Those reports are particularly useful, because they cover a period when the original retail energy price caps were wholly, or partially, still in place.⁵

Both of these reports reflect favourably on the level of switching being experienced under price caps. The electricity report reflects that 'by June 2000, 6.5m customers, one in four, had exercised their choice to change their electricity supplier, and every month 400,000 customers were changing electricity supplier.' The gas report reflects that 'since the introduction of competition began in April 1996 over four million customers have changed supplier - more than 20 per cent of all customers.'

The NAO does not convert this to a monthly figure, but if we assume a flat switching rate in the period after market opening in April 1996 to the 4 million households who had switched by January 1999, after weighting to account of the regional phasing in of the right to switch, we can infer a national gas switching rate of about 300,000 customers per month.

According to BEIS data, the average number of GB households currently⁶ switching supplier each month is around 420,000 for electricity, and around 330,000 for gas. So current switching rates, and those that existed during the period where GB retail energy prices were capped, are very similar. Figure 1 shows the GB switching rates for the period 1999-2017, including two data points reflecting the NAO's pre 2003 findings.

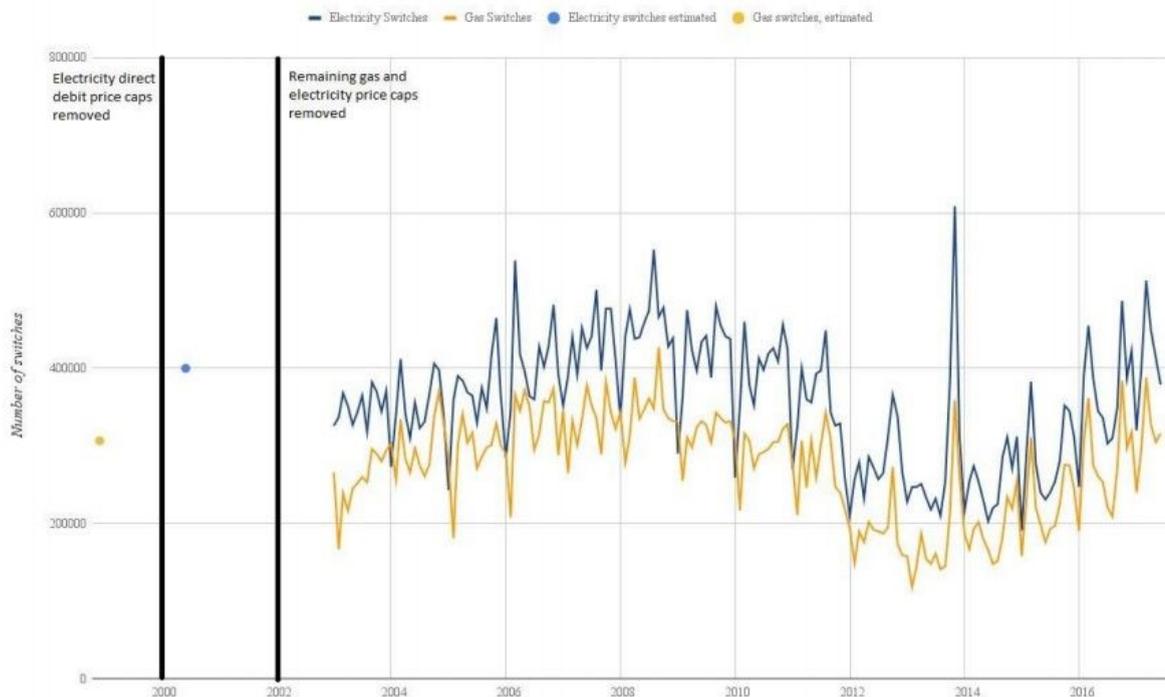
³ 'Giving domestic customers a choice of electricity supplier,' NAO, January 2001. <http://tinyurl.com/z6yush3>

⁴ 'Giving customers a choice - the introduction of competition into the domestic gas market,' NAO, May 1999. <http://tinyurl.com/j667o2n>

⁵ The cap on electricity direct debit prices was removed in April 2000, and the remaining price caps were removed in April 2002.

⁶ Based on October 2016 to September 2017 inclusive. 'Quarterly domestic energy switching statistics,' BEIS. <http://tinyurl.com/o2ux9mb>

Figure 1 - Monthly domestic switching rates for electricity & gas, 1999 - 2017



While there have been peaks and troughs in the switching rate over the last twenty years, the long term trend appears reasonably flat and bounded.

But though switching rates have been reasonably constant over time, price spreads have moved much more noticeably, and in recent years have started to stretch. The NAO reports suggest that a direct debit customer could have saved about £42/year⁷ from switching their electricity supplier in June 2000 (£60 in February 2018 prices, if adjusted using headline CPI) and about £22/year⁸ from switching their gas supplier in January 1999 (£32 in February 2018 prices). So a dual fuel direct debit switcher could have knocked about £90/year (in today's money) off their bills in the early period of competition, and it was driving similar levels of switching to those we currently see.

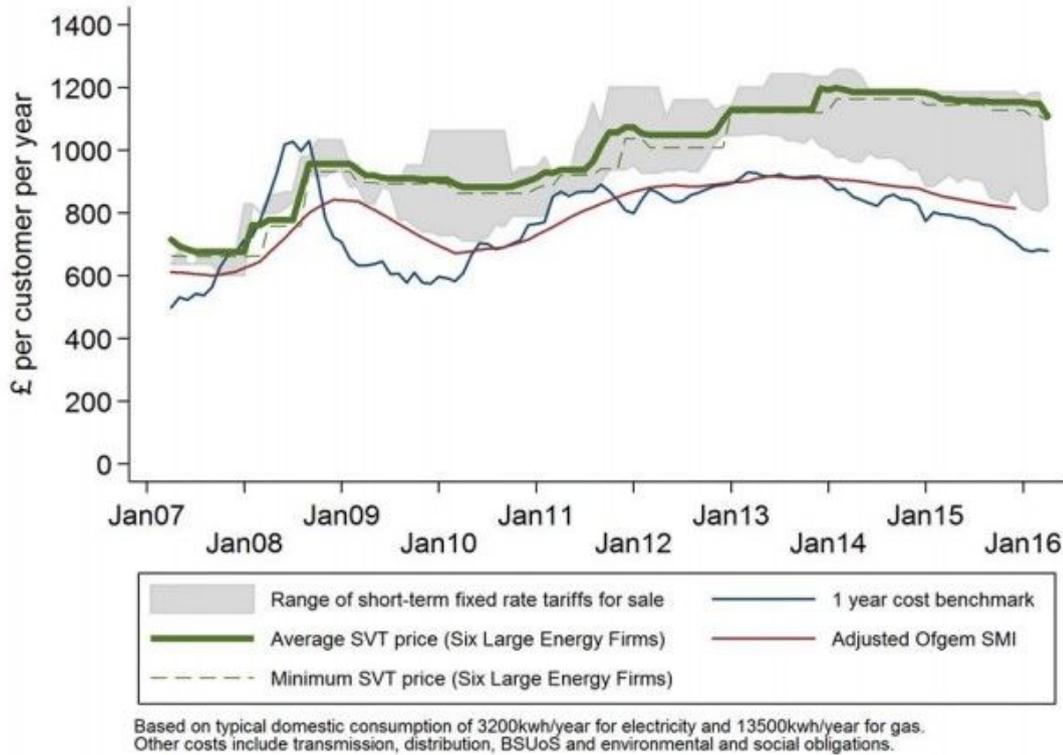
The CMA's 2014-16 investigation produced some data showing long run price spreads on the market. Figure 2 below is taken from its final report⁹ (the original can be found as figure 8.25 on page 412).

⁷ In the Manweb region, see figure 6 of the NAO report.

⁸ See Appendix 3 of the NAO report.

⁹ 'Energy market investigation: final report,' CMA, June 2016. <https://tinyurl.com/j3ye89l>

Figure 2 - The range of short-term fixed-rate tariffs on sale, average and lowest SVT price and a forward-looking industry-level benchmark of direct costs (based on direct debit, typical consumption customer) (Source: CMA, 2016)



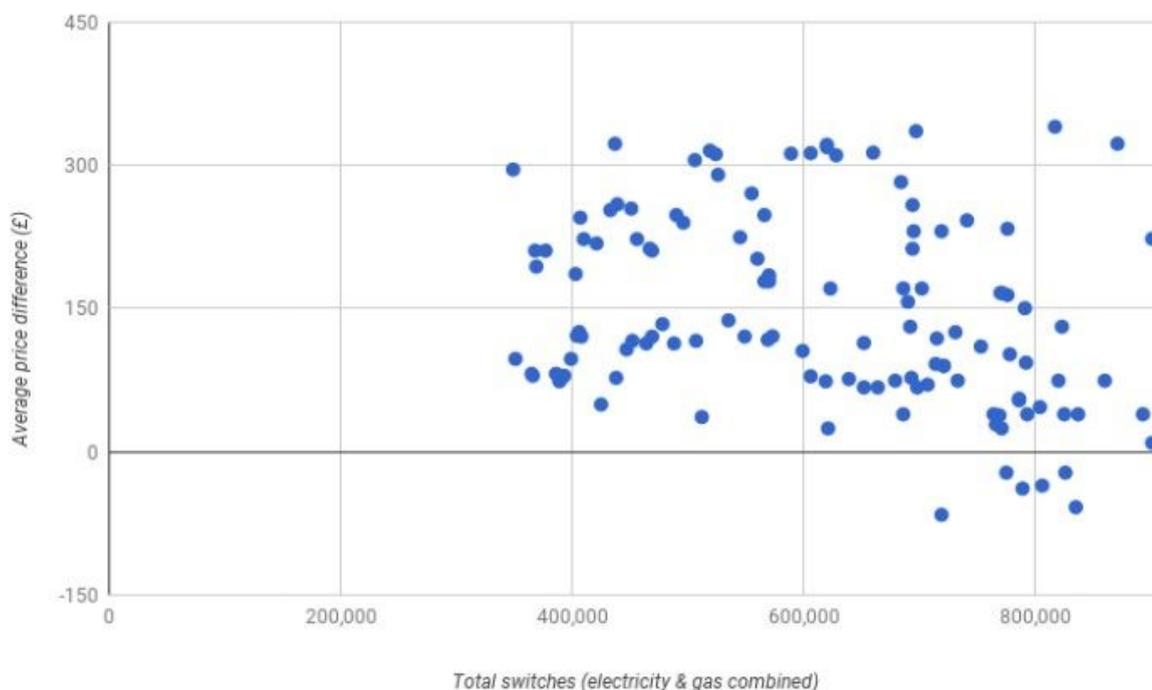
What you can see from Figure 2 is a progressive, if rather erratic, expansion in the premium paid by standard variable tariff consumers over the market leading deals over time. A typical customer paying the average SVT price could have saved less than £100 by switching in 2009, but over £300 by 2016.

We were very struck by the disconnect between this phenomenon of steadily increasing price spreads but flattish switching rates over the long run, and asked the CMA if it could share the data set behind the chart above so that we could do some correlation analysis. The price spread data in the following chart is largely derived from it, though we have extended the data series to June 2017 using the same criteria on what tariffs are included and excluded as the CMA.

Figure 3 below shows the relationship between the monthly switching rate (horizontal axis) and the spread of deals on the market (vertical axis) over the last decade. The average price difference is defined as the spread between the average Big 6 SVT and the cheapest short term fix being offered by any of the largest ten suppliers (the Big 6 plus Ovo, First Utility, Co-operative Energy and Utility Warehouse) at average consumption levels. Each data point is taken on the first

Monday of the calendar month. Long term fixes (those lasting for over 2 years), exclusive deals that were not available to all consumers, and Economy 7 tariffs are excluded. The number of switches is taken from BEIS' records of monthly electricity and gas switches.

Figure 3 - the poor relationship between the amount that a consumer could save by switching and the actual switching rate, April 2007 - June 2017 inclusive.



Intuitively, one might perhaps expect to see the data points clustering around an implicit line of best fit running diagonally upwards from the point where the axes meet to the top right corner, eg indicating that the more people can save, the more they switch. In fact, no such relationship exists - there have been periods where high switching rates coincided with high savings or low switching rates coincided with low savings - but there have also been periods where high switching rates coincided with low savings or low switching rates coincided with high savings. There are even a number of months with a negative price spread, relating to the gas price bubble of 2008, where cheap fixes traded at a premium to default tariffs, when higher than normal levels of switching were manifest.¹⁰

¹⁰ The six months with a negative spread were February 2008 to July 2008 inclusive.

No line of best fit is included in Figure 3 because it would be misleading to include one. The r-squared value of this data is 0.086, eg that there is no statistically meaningful relationship between the switching rate and the price spread.

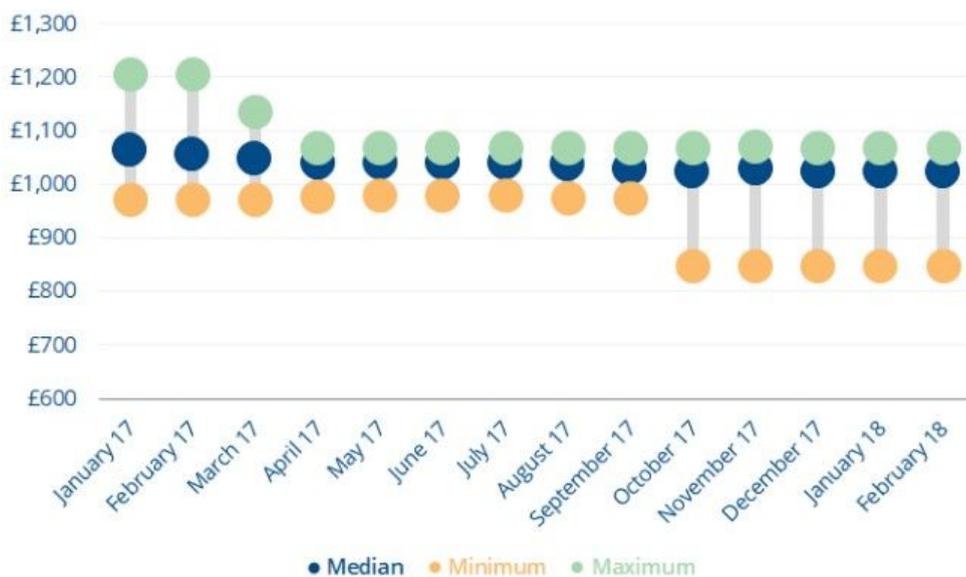
Other possible data sources

Discussions with price comparison websites suggest that they will hold data showing what proportion of searchers go on to switch supplier at different levels of revealed savings. We also expect that suppliers may hold similar data from their own price comparison engines and from call centre records.

We note from your paper that you could consider using stated preference evidence from consumer surveys, but would caution against this. In our experience, stated preference is usually less informative and accurate than revealed preference - we think a greater weight should be placed on how consumers actually behave than on how they say they will behave.

It may be possible to draw some inferences from the existing prepayment meter price cap, although the absence of public data on PPM switching levels may constrain this. In terms of price spreads, we saw an initial compression in the range immediately following its introduction in April 2017, but it seems to have now recovered to its previous level, as shown in Figure 4 below.¹¹

Figure 4 - The spread of prepayment meter tariffs on the market since January 2017, both before & after the introduction of the price cap in April that year.



¹¹ National average figures used, based on a dual fuel consumer using the Ofgem standard definition of medium consumptions. Based on figures taken on the first working Monday of each month. Dual fuel, not including Economy 7 consumers.

If you are looking at PPM switching levels as a guide, it will be important to understand the context behind potential consumer motivations. Some of the largest switching spikes seen in the wider market have coincided with price rise rounds - eg the huge autumn 2013 peak shown on Figure 1 coincides with a round of significant Big 6 price hikes, and the peak switching year of 2008 was one that saw huge price rises. Conversely, the majority of PPM customers saw a big price cut with the introduction of the cap in April last year. It is possible that may have dampened short term motivation to shop around - it would be interesting to see if the recent hike in the PPM cap that took effect in April this year has prompted increased engagement.

We would like to encourage Ofgem to establish and maintain regular public reporting of PPM switching rates to help inform public debate and understanding of engagement in that section of the market.

Other relevant issues

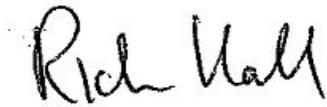
We can see some other considerations as potentially relevant to a decision on the inclusion of headroom.

The first of these is in relation to participation risk and the frequency of updates to the cap. The Bill requires that the cap should be updated at least twice a year, and the existing PPM cap is updated twice a year. Supplier costs can and will move over time, creating a risk that the cap may become more generous or meagre as they move away from the levels assumed by the cap. In theory, headroom could provide some protection to suppliers against the risk that the cap is unreasonably tight, by acting as a buffer. This could have the knock on effect of reducing the frequency with which Ofgem needed to update the level of the cap because the consequences - to suppliers - of any drift in actual costs versus allowed for costs would be less serious. We would not support this approach however, because it would create an asymmetric exposure to risk between suppliers and consumers - eg that suppliers would have a buffer against the risk that the price cap under-estimated their costs, but consumers would not have a buffer against the risk that it over-estimated their costs.

As we noted in our response to your first working paper, deflating headroom could also be used as mechanism to try and progressively drive out the inefficiency in the supply sector that was found by the CMA. We think an efficiency ratchet would more naturally sit in the calculation of the underlying cap, though.

Finally, noting that the introduction of the price cap is controversial, and may well be material enough to be subject to legal challenge, we can see some potential for a regulator to be attracted to the idea of initially including headroom, both to mitigate the likelihood of legal challenge and to soften the step change from the status quo to the new arrangements. We have anxieties that this could be a slippery slope and that, once introduced, headroom might become a permanent feature of the cap. If Ofgem were to consider headroom as a transitional measure, we would look to it to set out, and stick to, a clear roadmap for its subsequent phase-out.

Yours sincerely

A handwritten signature in black ink that reads "Rich Hall". The signature is written in a cursive, slightly slanted style.

Richard Hall
Chief Energy Economist