Illuminating the energy market: Encouraging greater switching

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Key points

- Household expenditure on energy has more than doubled since 2003, from £13.5bn to over £30bn – an increase of 126%;
- Consumer distrust in energy suppliers currently stands at 59%, making energy the most distrusted of all consumer industry sectors;
- Switching rates have fallen (from 9,584,000 in 2008 to 5,622,000 in 2012) and a majority of domestic consumers (62%) have never switched;
- An estimated £1.1bn or £195 per household was saved in 2012 by switching;
- Those who stand to gain most from switching are the lower social groups, but these are the groups least likely to switch;
- Increased switching can have positive implications for public spending.

Introduction

The current cost of living 'crisis' has seen the energy sector become the focus of public and political debate. According to Citizens Advice, by December 2013 the big six energy suppliers will have raised their prices by over a third since 2010. Suppliers insist that rising costs reflect the increasing wholesale price of gas and electricity but with an eye on the 2015 General Election, politicians in all parties are considering ways to reform the market to deliver a better deal for consumers.

The Government and Opposition disagree on how best to tackle the energy price problem. Labour contends that wide-scale reform is required to the supply side. They have pledged to freeze energy prices for 20 months so that the big firms can be split up and made to answer to a tougher regulator.[1] On the other hand, the Coalition Government argues that the market can be reformed through consumer behaviour, including higher switching rates.

[1] Ed Miliband MP, *We've been paying too much*, Labour Party Website (2013)

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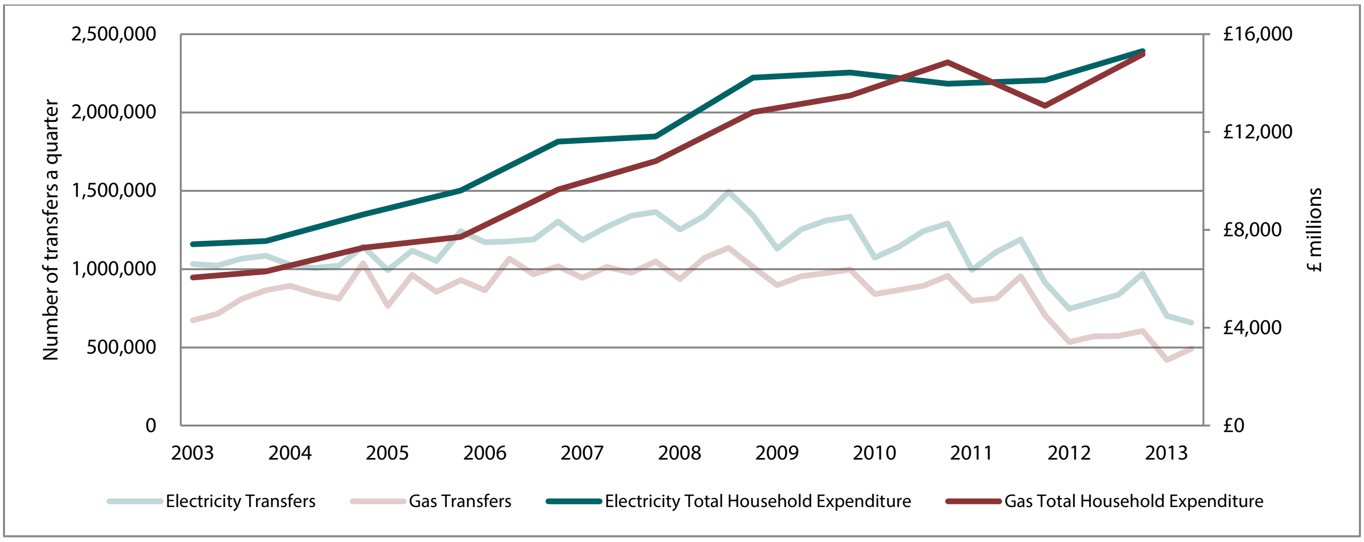
The success of the Government's approach depends in large on what scope there is for increased switching in the energy market. This briefing paper brings together the evidence on switching, starting with the conundrum of prices rising in tandem with declining switching rates. It examines the characteristics of those who do switch, and considers what policymakers can do to boost consumer trust in the energy market.

The Social Market Foundation has a long tradition of analysis in consumer markets. This paper is informed by recent work on consumer trust in financial services and is the first of a series of briefings about the energy market in the UK.

A 'perfect storm': rising prices, falling trust and declining switching

Total household expenditure on gas and electricity has been steadily rising over the past ten years, with UK households now spending over £30billion per year on gas and electricity, compared to £13.5billion in 2003 (in today's prices) – an increase of 126%. Switching rates, however, have been on the decline from a peak in 2008. Chart 1 details gas and electricity price increases since 2003 compared to switching rates over the same period.

Chart 1: Prices rise as switching declines



Source: Statistics for domestic energy transfers (DECC, 2013) and Annual domestic energy bills (DECC, 2013)

A recent Ofgem report found that 62% of domestic customers and 56% of businesses had never switched energy provider. [2] [3] But low switching rates alone are not an indicator of a poorly performing market: people may choose not to switch if they are satisfied with their product and feel it is offering good value for money. Looking internationally, as Chart 2 shows, the UK compares favourably to other European countries, with more energy switchers than most, suggesting that low switching rates in energy are fairly common. Energy switchers are also more prevalent in the UK than in other comparable markets, such as broadband and banking, as Chart 3 demonstrates.

Chart 2: UK energy switchers in international context

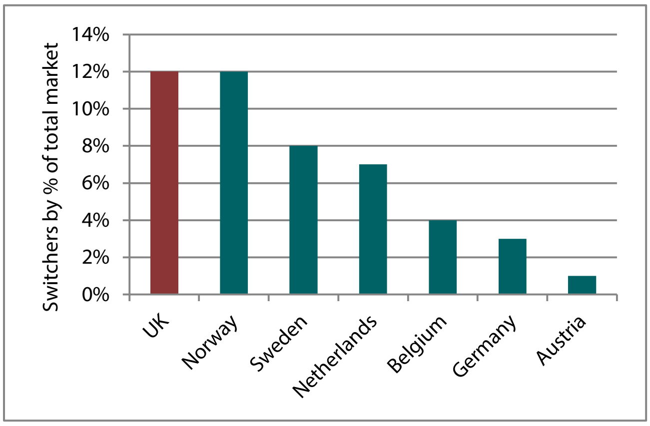
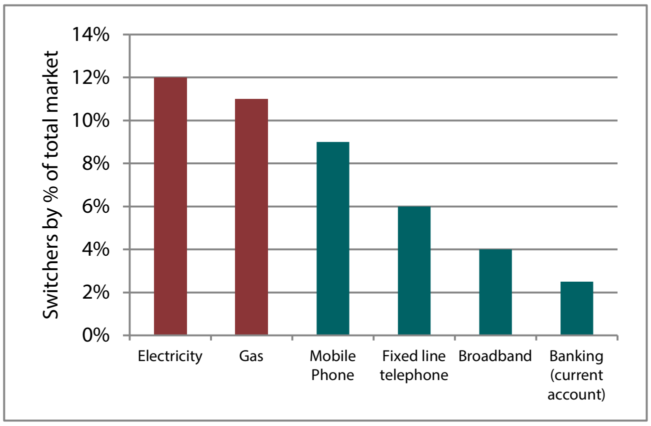


Chart 3: UK energy switchers compared to other consumer markets



Source: 'Switched on? Consumer experiences of energy switching' (Consumer Focus, 2013) and Empowering customer choice in electricity markets (International Energy Agency, 2011)

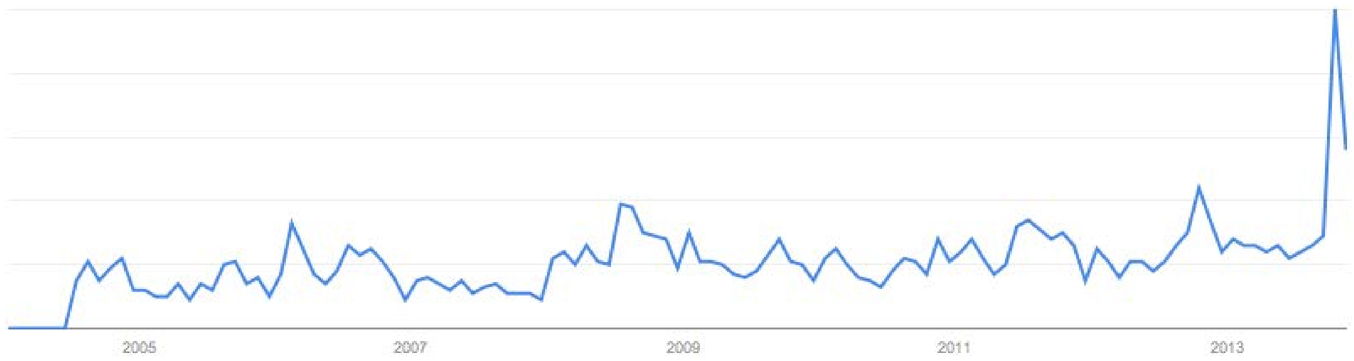
This may suggest that the scope for increasing switching rates is limited. However, when viewed through the lens of consumer trust and satisfaction, the problems in the UK's consumer energy market become clear. A recent Which? report found that distrust in energy suppliers was at a record high of 59%, making energy the most distrusted consumer industry. [4] Moreover, a quick look at Google Trends data suggests that people are seeking to compare prices more and more, despite low switching rates.

[2] Quantitative Research into Non Domestic Customer Engagement and Experience of the Energy Market, Accent (2012)

[3] Customer Engagement with the Energy Market - Tracking Survey dataset, Ofgem (2013)

[4] Consumer Insight Tracker, Which? (2013)

Chart 4: Google Trends data for the phrase "compare energy prices" since 2005



Source: Google.com/trends/explore

Rising prices, falling trust and declining switching rates point to a 'perfect storm' in the energy market, whereby consumers are not satisfied with the deals they are getting, but are not motivated to do anything about it, despite the impact upon their own finances. A closer look both at the benefits that switching could bring, and the characteristics of switchers, can help inform what this means for policymakers.

Does switching save money?

There are potentially significant savings to be made by switching energy supplier. According to Ofgem, households expected to save, on average, £195 the last time they switched. [5] If this is multiplied by the number of switchers in 2012 (5.6million, according to DECC), then an upper rough estimate of £1.1 billion of savings a year can be calculated to give a sense of scale to the impact of switching.

We examined the Ofgem data further, breaking it down by age and social grouping. The findings reveal that those most likely to save the most by switching are the bottom social groups.

[5] Customer Engagement Survey, Ofgem (2013)

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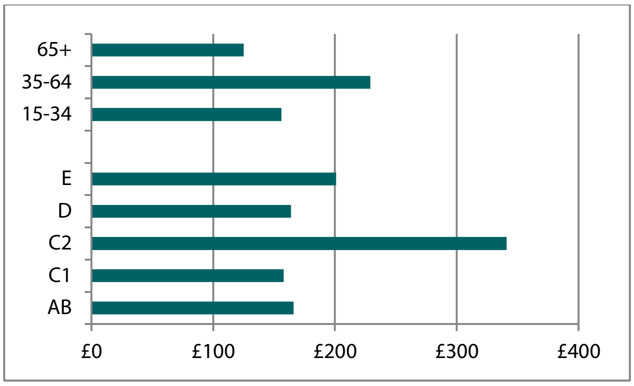
Chart 5: Expected savings per household by age and social group



Source: Customer Engagement Survey, Ofgem, 2013

Who is switching?

Given that the biggest savings are to be gained by those in the bottom social groupings, one would expect these groups to be switching most. But a closer look at the data reveals that this is not the case. In fact, in 2012, the top two social groups were almost twice as likely to switch supplier as the bottom social group - 26% compared to 15%.[6] Among the lowest switchers were the elderly, black, minority and ethnic groups and those in rented accommodation.[7] The proportion of those who have never switched is also heavily weighted to those in the bottom two social groups and black, minority and ethnic groups.[8]

[6] Customer engagement survey, Ofgem (2013)

[7] Switched on? Consumer Focus (2013)

[8] Customer Engagement tracking survey, Ofgem (2013)

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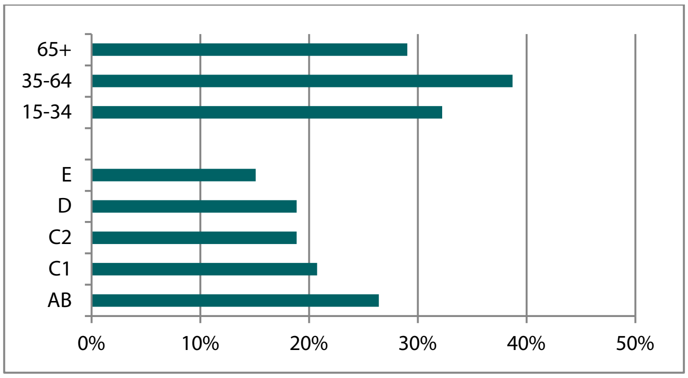
Chart 6: Likelihood to switch gas supplier by age and social group



Data gathered from Customer Engagement Survey p.40-51 (Ofgem, 2013)

Barriers to switching

Why certain groups are more disengaged than others is unclear. According to a study by Consumer Focus, the most common reason for disengagement with the market was that the time and effort required to navigate energy options and prices was disproportionate to what consumers believed they would ultimately gain. The complexity of tariffs was seen as further proof that suppliers do not work in the best interest of the consumer.

Other barriers to switching include fear of double billing, loss of energy for a period of time and concerns that prices will go up shortly after switching.

Navigating information on switching

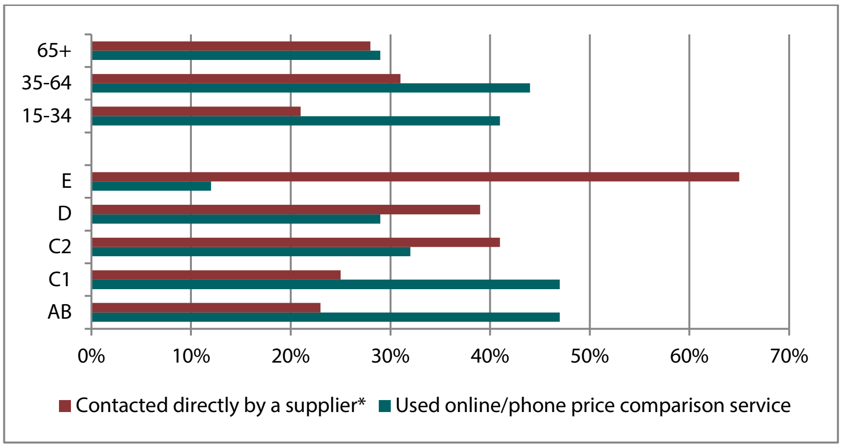
How people access information from the energy sector is a significant barrier to finding a good deal, even if people do want to switch. A recent study found that 36% of those who made the decision to switch were directly contacted by a salesperson of a particular supplier (either at home, over the phone or in a public space).[9] Customers contacted in this manner are likely to receive partial information (such is the bias of a salesperson to a particular supplier). Lower IT literacy and usage among more vulnerable sections of the population (namely the elderly and lower social groups) is

[9] Switched on? Consumer Focus (2013)

also likely to be part of the explanation, as many of the cheapest tariffs and price comparison services are exclusively available online. [10]

As Chart 6 below shows, the groups with higher switching rates are relying more on comparison services. This provides a context for Energy Minister Edward Davey's call to train 500 volunteers to help vulnerable people navigate tariff complexity and switch to the cheapest deal. [11]

Chart 7: Prompts for switching by social group and age



Source: Access to information for Switching (Switching on?, Consumer Focus, 2013)

Supplier behaviour may have also exacerbated the situation. An Ofgem report noted that while "we found no evidence of a cartel, we have seen evidence of companies reducing risk from competition through adopting similar pricing strategies". [12]

Similar pricing strategies could be both a cause and a response to consumer disengagement. It reached a peak in the winter of 2010, when the difference between 'The Big 6's' main tariffs for dual fuel by direct debit was just £22. [12] This was most likely in response to the 2008 financial crisis which saw wholesale prices increase significantly and as a result suppliers adopting 'risk-free' pricing strategies. This could explain the steady decline of switching rates since 2008, as

[10] UK Adults' Media Literacy, Ofcom (2011)

[11] Edward Davey MP, *Annual Energy Statement*, Hansard (2013)

[12] The Retail Market Review - Findings and initial proposals, Ofgem, (2011)

there has been low incentive to switch due to there being little discernable difference in tariff pricing between providers.

The public spending benefits of greater switching

The individual benefits of switching supplier are clear. However, increased switching rates could have a positive knock-on impact upon public spending too. Low switching rates among vulnerable groups such as the elderly and low income households suggest that government spending (in the form of Winter Fuel Allowance, Cold Weather Payments and Warm House Discounts) may not be the only way to help with utility bills. Reforms that encourage, and make switching easier for these groups could allow significant savings and lower the cost of living for those who need the most help. If that pressure can be eased by higher rates of switching, then it may become easier to reduce expenditure on state benefits in this area, an issue that has been raised by several politicians and commentators.

Switching could also help mitigate the costs of green levies on energy. Green levies add, on average, £112 to energy bills.[13] Interestingly, Ofgem data suggests that people who do switch expect to receive savings around this figure.

The Government is currently considering whether to remove green levies from energy bills and fund commitments to reduce carbon through public spending. This will shift the burden of cost from energy bills to tax bills rather than reduce it overall. For example, to fund the Energy Companies Obligation scheme (one of many schemes funded by the current levy) the government would have to raise an extra £1.3billion a year in general taxation or to cut public spending elsewhere by the same amount.[14] Reforms to increase switching may be a better solution to tackling energy bills as the resulting savings will be of a similar magnitude to the current costs of green levies and will not have to be offset by higher taxes or lower public spending.

[13] Estimated impacts of energy and climate change policies on energy prices and bills, DECC (2012)

[14] Tim Ross, *New Green tax threat in energy bills 'deal'*, The Daily Telegraph (2013)

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Solutions to the switching conundrum

1. Simpler tariffs

Ofgem, in its most recent review of the retail market, has made proposals to address many of the information problems, such as stripping away tariff complexity and introducing a standardised metric for price comparison (Tariff Comparison Rate). [15] The tariff comparison rate (TCR) is scheduled to be implemented in March 2014 and will be an energy equivalent to the annual percentage rate (APR) used in the banking and savings sector. How the TCR will be calculated is yet to be decided but the aim is to provide a comparison tool that allows consumers to take an 'at a glance' look at supplier tariffs.

The government has also pledged to increase the personalised assistance available for vulnerable groups. As we have seen in this briefing paper, these groups could make significant savings by switching but are not pursuing it as actively as those who have better access to information and advice.

2. Quicker switching

Energy and Climate Change Secretary Edward Davey has highlighted the time it takes to switch as a barrier to switching. UK customers face a wait of 5 weeks to change supplier which compares poorly to Norway where it takes just 6 days. [16][17] The government is aiming to reform the market so that switches take no longer than 24 hours. [16] The possibility of a 24 hour turnaround on their supplier could certainly nudge consumers to be more responsive to price changes.

Collective switching has also been pushed by the government in the hope that consumers grouping together will acquire greater purchasing power. This may make it more likely both that consumers will switch and that suppliers will bring prices down in anticipation of higher levels of switching to keep or build their market share.

3. Fixed term contracts

[15] The Retail Market Review – Final domestic Proposals, Ofgem (2013)

[16] Edward Davey MP, *Annual Energy Statement*, Hansard, (2013)

[17] Empowering Customer Choice in Electricity Markets, International Energy Association, (2011)

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One solution to achieve 100% engagement on the question of switching would be to institute fixed term contracts, compelling consumers to go out and find the best deal every time the contract comes to an end. A previous SMF article, 'How to kick-start stalled markets', suggests that fixed term contracts may be particularly well suited to markets with traditionally high levels of customer dissatisfaction yet low switching rates. [18] Consumers in these markets do not regularly check the market to see whether they could get better quality or a cheaper price elsewhere because they have become disenchanted with the options. Yet their disenchantment makes it all the more likely that suppliers will fail to innovate or compete. Fixed term contracts could sharply change behaviours on both sides with consumers being forced to shop around and suppliers working harder to keep and acquire their market share.

4. Increased competition

An increase in competition could revitalise price competition as new entrants would look to take quick initial market share by undercutting current tariffs giving consumers reason to switch. Greater transparency in the wholesale market would be an initial step to understanding the dominance of 'The Big 6' and the impact of some firms being involved in both the generation and supply of energy. All of this will require long term structural changes within the market, which should only be pursued following careful study, and will be little help for those worrying about their energy bills this winter.

For the moment, switching is likely to be the policy lever with the most short-term potential and there are options to do more with switching, as discussed in this paper, that have not yet been explored.

[18] John Springford, *How to kick-start stalled markets*, Social Market Foundation (2012)

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