

Designing policy to influence consumers

Briefing note 6: consumers and utilities

When designing policy to influence the way in which people purchase energy and other utilities, you must take into account the way in which people make choices.

Consumer choice is strongly influenced by mental short-cuts and emotional factors rather than just a rational assessment of information on quality and price. Often these short-cuts lead to biased decision-making which means consumers do not always buy what is best for them. Effective policy must work with these mental short-cuts and account for the many factors that influence consumer choice.

Those working on consumer policies related to energy and utilities should remember that consumers...

- **... are more averse to losses than gains.** When weighing up the advantages and disadvantages of a choice, the disadvantages may be considered more than the advantages. This means consumers can overestimate the costs associated with switching utility suppliers and underestimate the benefits. Introducing a green tariff as the default choice increases uptake while still giving consumers the freedom to choose an alternative if they wish.
- **... value the immediate future too highly and do not value the distant future enough.** There is also a tendency to favour immediate rewards and avoid immediate costs. This makes energy contracts with very low initial rates particularly attractive. Work with retailers to ensure the long-term costs associated with tariffs are easy to understand.
- **... struggle with complexity.** Complicated tariff structures are difficult for people to grasp and can mean that consumers are put off making energy purchasing decisions. Policy should work with utility companies and independent organisations to develop consumer support mechanisms, like price comparison websites, that help individuals compare the tariffs and prices of different suppliers.
- **... are overwhelmed by too much choice.** Policy could consider restricting the number of tariffs on offer to consumers by using competitive procurement to select the cheapest few tariffs. This would still meet consumers' preferences while ensuring competition is maintained.
- **... can be pressured into making poor decisions.** This can be particularly the case with door-to-door salespersons, or when companies ring individuals at their homes. 'Cooling off' periods allow consumers to reverse or cancel any decisions to switch utility suppliers, away from the pressure of the sales environment.
- **... may feel a sense of loyalty to a former state supplier.** This can act as a barrier to competition, as consumers may feel an unwarranted obligation to remain with the supplier. Policy should consider the impact of branding on consumer behaviour and, where appropriate, ensure that existing suppliers are rebranded to avoid misplaced loyalty.

Tailor policies...

- **... by ensuring they are based on specific consumer research.** Make sure you know how consumers will react to different formats of your policy instrument. Consumers often make choices automatically, or with little thought. This means it can be difficult to correctly identify their reasons for purchasing a product. Policy needs to be based on research that explores behaviour in different contexts.
- **... by recognising that all people are different.** Consumers are motivated by different things. Attitudes towards the environment vary, which means that some consumers will be more motivated to buy energy from a green energy supplier than others. Identify the different ways in which different groups of people will react to policies, and do not assume that one policy will change the behaviour of all consumers. A mix of policy options is likely to be required to achieve widespread changes in consumer behaviour.

This briefing identifies factors known to affect the way in which people make choices when purchasing energy and utilities. It considers what is known about the way in which people choose their energy suppliers, before considering how consumers may be encouraged to think differently about their domestic use of energy.

Consumer behaviour and market deregulation

Spending on energy takes up a notable part of individuals' income. In theory, due to their homogenous nature, deregulating utility services should encourage market competition between different suppliers. This in turn should drive down prices. However, there is growing evidence from deregulated markets that domestic consumers are not switching suppliers as anticipated. In some circumstances, it has been estimated that consumer welfare would have been greater if the state had regulated prices on consumers' behalf.

A recent review of the outcome of electricity market deregulation in a number of states and countries suggests that only in England and Wales did market forces benefit consumers (see Table 1). In the other examples, the success that was achieved was reached following artificial intervention by the regulator. Even in the case of the English market, consumers were reluctant to switch suppliers; it took annual savings of 28% to lead 60% of consumers to switch. This still left 40% of consumers willing to give up a considerable amount of money rather than switch supplier.

Table 1. Outcomes of electricity market deregulation in various countries and state

Jurisdiction	Switch rate		Key barrier/success factor
	Rate	Year	
England & Wales (UK)	>50%	2004	Successes: Significant savings (up to £75)
New Zealand	25%	2005	Barrier: Complexity of switch over process
Texas (US)	27%	2005	Successes: Increased price for default services
Pennsylvania (US)	~4%	2003	Barrier: Complexity: Guide 'akin to IRS tax calculation worksheet'
Alberta (CA)	6%	2003	Barrier: Consumer inertia
Maine (US)	1%	2003	Barrier: Availability of standard regulated offer alternative
New York (US)	6.4%	2005	Success: 'Switch and save' – random assignment and discounts

(Source: Collated from Brennan, 2007)

Reasons for the low rate of switchover

- **Consumers perceive a number of costs associated with switching.** Utility supply contracts tend to be indefinite or automatically renewed. This means that, when buying energy for example, consumers do not have the opportunity to learn from repeated buying. Instead, when considering a move to a new utility supplier, consumers face both search costs and switching costs.

Search costs involve consumers having to spend time, effort or money in order to gather information about different suppliers and their products or services. In the case of energy, search costs might include the time taken to visit a price comparison website, or the effort taken to actually search the site.

Switching costs are faced when consumers move from one supplier to a new supplier or service provider. These could include transactional costs (for example, the time it takes to actually switch supplier or perhaps the charge incurred for switching), uncertainty costs (for example, a consumer may know they receive good boiler breakdown service from one supplier, but feel uncertain about the service provided by a new company) and psychological costs (for example, loyalty to a brand or company, even if there are no obvious benefits).

While these costs are well understood by regulators, the low switch rates observed in deregulated markets suggest that efforts to reduce these costs have had only limited success. One reason for this is that individuals avoid giving things up. This is because consumers are more averse to losses than they are to gains, and require more to part from a good than to obtain it. People also weigh up the advantages and disadvantages of a choice relative to the current situation. When consumers evaluate a move to a new energy supplier, the disadvantages can seem larger than advantages leading to a tendency to favour the present situation. This may lead consumers to over-estimate the cost of switching utility supplier but to underestimate the benefits of switching.

Another reason that consumers may miscalculate the costs and benefits of switching suppliers is because people value the immediate future too highly while tending not to value the future enough. This inconsistent valuation of future costs varies across different types of behaviour. For example, we tend to favour immediate rewards and avoid immediate costs. High discount rates can make energy contracts that offer very low initial rates and much higher rates later on, more attractive than they actually are.



- **Consumers avoid complexity.** When we make decisions, we are often caught between two competing thought processes. Slow, reflective thinking enables us to consider some of the costs and benefits of a choice before making it. On the other hand, there are our emotive thoughts, which often persuade us to buy things that might not be beneficial in the long term. Despite efforts by policy to help consumers make informed choices, there are frequently situations when our ability to engage in slow reflective thinking is hampered. This leads us to make decisions quickly without fully considering all of our options. For example, only 8 – 19% of people who switched suppliers in the UK actually selected a cheaper supplier, a figure only slightly higher than if people had just picked suppliers at random. Those who did switch only captured less than half of the gains available to them. It is thought that consumers' ability to switch was limited by the complexity of the tariff structures on offer.

- **Consumers struggle with ‘too much choice’.** When faced with a lot of choice, people have difficulty managing their decisions. If choice becomes excessive, consumers tend to consider fewer choices, process less overall information and evaluate information differently. In addition, consumers may be less happy with a decision when they closely consider their options than when they use other, quicker, more emotional ways of making a decision. The more choice there is, the more opportunities consumers feel have been lost and the less happy we will be with our eventual choice. In situations when choice is complex, or the number of choices is overwhelming, consumers may hesitate and may sometimes put-off making a decision to the future. This is known as ‘choice avoidance’. It is believed that choice avoidance is common in deregulated utilities because:
 - There is no immediate incentive to choose because the benefits of a choice are in the future
 - Consumers rarely switch suppliers so have only little experience in the market
 - Rolling contracts reduce any immediate requirement for consumers to make a choice.
- **Consumers often do not read the information provided.** It is often thought that when individuals make poor choices it is the result of misinformation or a lack of information. Across many areas of consumer policy, information provision is favoured as a policy tool because of its relative low cost (compared to other options) and because it is assumed that too much information cannot harm consumers. This is not always the case. In part, the limitations of information provision stem from the fact that consumers rarely search out, read or properly digest all of the information that may be available to them when making a decision. In addition, consumers might not process all the information available to them if the benefits of processing the information are thought to be limited.
- **Consumers often feel loyal to their supplier.** Consumers may feel loyal to their energy or utility supplier, particularly immediately after deregulation when they may have been with their present supplier for a long period of time. For example, in the UK, 82% of residential telecom lines remained with the privatised supplier even after 20 years of deregulation within the British telecom’s market. This was attributed to the fact that 75% of customers viewed themselves as loyal to their supplier. This loyalty can be affected by the structure of the privatisation process. The fact that rates of switch-over have exceeded 50% at times within the English electricity market is thought to result from the fact that electricity producers were forced to separate their retail operations from generation and distribution. This meant it was less clear to consumers who to be loyal to.
- **Consumers may make poorer choices when pressured by a salesperson.** This is particularly true when salespeople carry out door-to-door sales, when they visit households. When pressured, consumers are less likely to think carefully about a decision and may be more likely to make a choice that reflects the pressurised situation rather than being the most beneficial choice in the long-term.

Policy opportunities

- **Using default tariffs.** A default is a standard tariff which is supplied unless the consumers requests otherwise. Defaults can work in one of three ways. Firstly, consumers may rely on them to reduce the effort needed to make a difficult decision. In the case of energy purchasing, this might be because they are overwhelmed with choice or simply because they do not care much about who supplies their energy. Secondly, defaults can be taken to indicate endorsement of a provider by those who choose the default. Finally, defaults can take advantage of consumers’ resistance to change.

Box 1: Real world consumer behaviour example: green energy defaults

Default tariffs have been used by the authorities in two German areas who offered choice but made green energy the default option. The context of these examples is as follows.

Schonau: As a reaction to the Chernobyl disaster in the 1980's, campaigners in Schonau resulted in 1997 in the take-over of the electricity grid and the establishment of the green tariff as a default. The population was not otherwise known for their environmentalism and voted 52% to 48% in favour.

Energiedienst GmbH: In 1999, Energiedienst GmbH, a company supplying a grid area in southern Germany offered three tariffs instead of one. A waterpower tariff was used as the default tariff as reported here, with grey being 8% cheaper and a 'greener' tariff 23% more expensive.

The result is that 94% and 99% of customers kept their default green tariff. Because the examples refer to 'green' energy, the purchasing of which has a moral component, consumers might also have found it even more difficult to make a choice. Sticking with the default seems to allow one to bypass a stressful and awkward decision.

Source: Pichert (2008)

- **Make consumer research easier.** Consumers are increasingly using the Internet to research new products and services, including utility suppliers. Online price comparison sites, which allow consumers to compare the tariffs and prices of different suppliers, are becoming an increasingly important means by which consumers find out about products and prices. It has been suggested that an important challenge for policy is to create environments that enable markets, like electricity and telecoms, to utilise the lessons of price comparison sites, so that individuals can make more informed choices, more easily.
- **Cooling-off periods.** Consumers often make decisions in emotional situations, for example when under pressure, that they would not make in a calmer, more rational state. 'Cooling off' periods allow consumers time to reconsider their purchasing decisions, away from the pressure of the sales environment. In the context of utilities, 'cooling off periods' would allow consumers to reverse or cancel any decisions to switch utility suppliers.

Domestic energy use: the impact of the behaviour of others

Lessons from marketing not only inform improved product policy, but also provide useful findings for those seeking to reduce the domestic use of energy in homes. The information provided by power companies and governments is just one of a number of factors, including the influence of other people, which impact on how people behave. Policies that rely on information provision alone are likely to fail. For example, in the summer of 2000, California experienced an energy crisis. Within this context, a variety of different interventions were tested that encouraged people to conserve energy in their homes. Across several approaches, the least effective method was simply providing information.

Social marketing campaigns highlight behaviours that are common or socially acceptable. Examples of successful social marketing campaigns include campaigns that have reduced domestic energy consumption by providing feedback to households on the average level of energy consumption in their community.

The briefing provides a summary of evidence from behavioural economics and marketing relating to the consumer purchasing of utilities. Full references for all of the evidence presented here can be found in the full project report 'Designing policy to influence consumers' from which a series of briefs has been produced, including an overview of consumer behaviour and product policy (Briefing note 1).