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# An Honest Broker: Are Non-Domestic Energy Customers Getting a Fair Deal?

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## Introduction

The Competition and Markets Authority (CMA) recently concluded a two-year inquiry into the British electricity and gas markets. Whilst much of the media attention focused on the domestic retail market and wholesale markets for electricity, the inquiry also examined the retail market for the non-domestic (microbusiness) segment.<sup>1</sup> The inquiry heard complaints that non-domestic customers were paying excessive amounts for their energy, in part because Third Party Intermediaries (TPIs or brokers), prevalent in the sector, had charged excessive commissions.

The CMA stopped short of a full probe of the TPI segment, focusing instead on measures designed to improve the general effectiveness of non-domestic competition (eg a mandate on suppliers to publish standard tariffs to facilitate the entry of price comparison websites for non-domestics). In this article, we review the performance of TPIs in the Great Britain (GB) energy market, drawing on evidence from the CMA investigation, as well as from our own preliminary analysis of TPIs' commission rates.

## TPIs Are a Major Sales Channel for Suppliers to Reach Non-Domestics

TPIs are brokers that connect energy customers to electricity and gas suppliers. Ofgem, the energy sector's regulator, estimates that there are more than 1,000 TPIs serving the non-domestic market, ranging from one-person shops to large advisory firms.<sup>2</sup> Estimates of the size of the market vary, but some commentators have argued that the market is worth £250 million in commissions per year.<sup>3</sup>

TPIs represent an important sales channel for suppliers to reach non-domestic customers. According to the CMA, brokers bring the Big Six energy suppliers around 30%, on average, of their non-domestic sales and are the main sales channel for independent suppliers entering the market.<sup>4</sup>

Brokers serve the entire non-domestic segment of the energy market, from microbusinesses to large commercial and industrial customers; however, large businesses are more likely to use brokers than small ones. A 2013 survey conducted on behalf of Ofgem found that 11% of microbusinesses chose their energy contract using a broker, compared to 21% of medium-sized businesses and 23% of large businesses.<sup>5</sup> The CMA attributes the higher proportions of medium and large businesses using brokers to two reasons: first, small businesses may not trust brokers; second, brokers may lack interest in pursuing small businesses due to lower fees in absolute terms.<sup>6</sup>

Broker business models come in many forms. A broker may do any or all of the following for customers:

- Present offers from one supplier;
- Present offers from multiple suppliers;
- Run tenders on behalf of their client;
- Give advice on appropriate tariffs, contract lengths, buying strategies, etc.; and
- Give advice on energy efficiency and wider energy programs like renewables.<sup>7</sup>

The standard charging model used by TPIs is a supplier-pays model, ie energy suppliers, rather than customers, pay a commission to TPIs, usually in proportion to the amount of energy the customer uses (eg a fixed commission per kWh or a percentage of the bill).<sup>8</sup>

## Commissions May Be Too High and May Distort Incentives

The customer-broker relationship is an example of a situation that economists refer to as the principal-agent problem, as discussed in “Principals, Agents, and Moral Hazard” on the next page. The commercial logic for a customer (the “principal”) to use a broker (the “agent”) is to leverage the broker’s specialist expertise to procure electricity at a cost-effective rate. The benefit of using a broker, therefore, relies on the broker acting in the interest of its client and sourcing a better deal than the client can get on its own.

In practice, the supplier-pays business model may not provide the right incentives for the broker to seek the best deal for the client. EDF Energy suggested to the CMA that brokers “balance” their own interests against those of the client. This balance may tip depending on incentives offered by suppliers to sell more at higher prices. The CMA cited a particular case highlighted by Scottish Power, where some suppliers will raise the commission for brokers if they get the customer to accept a higher price.<sup>9</sup> Similarly, a broker may have an incentive to run tenders that favour suppliers that pay higher commissions, rather than those that offer the best deal to the customer.

The CMA cites evidence that customers do not understand how much they are paying for their brokerage service or even that they are paying for the service at all. A BMG Research survey of microbusinesses and small businesses published in 2014 and 2015 revealed that a low percentage of respondents that used a broker knew that they had been charged for the service: 5% in 2014 and 8% in 2015.<sup>10</sup> Moreover, Ofgem informed the CMA that small non-domestic customers may not be “shopping around” by contacting suppliers directly or going to another broker for a second quotation. Given this lack of information and understanding of the broker business model, the CMA suggested that customers may only be exerting weak downward pressure on commissions.<sup>11</sup>

The CMA reports that a minority of TPIs have been accused of using aggressive sales tactics, making misrepresentations, and engaging in other unscrupulous behaviour in an attempt to sign up customers.<sup>12</sup> For example, the CMA cited one supplier that claimed “some TPIs charged excessive commissions of 2-3p/kWh”,<sup>13</sup> which amounts to 20% to 30% of a 10p/kWh<sup>14</sup> electricity bill.<sup>15</sup> The CMA also mentions that four of the Big Six suppliers have unilaterally capped commissions for TPIs,<sup>16</sup> which indicates they are concerned about their customers being charged excessive commissions.

## Principals, Agents, and Moral Hazard

The potential for misaligned incentives between brokers and their customers is an example of a “principal-agent problem”, in which an economic actor, the principal, contracts with an agent to undertake some activity on its behalf. The concept was mentioned in Adam Smith’s *The Wealth of Nations* in 1776, and economists developed formalised theories starting in the 1960s.<sup>17,18</sup>

Principals may have a variety of problems contracting with agents. In the case of TPIs in the energy sector, the most significant is likely to be “moral hazard”, defined as “actions of economic agents that maximize their own utility to the detriment of others”.<sup>19</sup> Moral hazard may be a problem any time one entity (the principal) contracts with another (the agent) and cannot perfectly enforce the contract. For example, the principal cannot monitor the subsequent behaviour of the agent because the outcome of an agent’s behaviour is uncertain or cannot be measured.

There have been a number of high-profile cases involving moral hazard problems in recent years:

- **Payment Protection Insurance:** Payment protection insurance (PPI) is sold in the UK with some loan products, ostensibly to protect customers from missing payments due to illness or job loss. In 2005, the UK’s Citizens Advice accused the banks selling PPI of making the insurance products too expensive, selling them intentionally to people who could not make claims, and specifically avoiding selling them with products that could commonly lead to debt. Here, we have a principal (the customer) who relies on an agent (a bank) to sell them insurance that is in their interests. The bank, however, put its interests as a business first.<sup>20</sup>
- **Wealth Management:** In the US, university employees sued three major universities—the Massachusetts Institute of Technology (MIT), New York University, and Yale University—in 2016 in relation to wealth management practices. Employees of the universities (the principals) claimed that these institutions (the agents) did not monitor excessive fees being charged for portfolio management and failed to replace poorly performing funds with well-performing ones.<sup>21</sup>
- **Banking:** During the 2008 financial crisis, the UK government (and many others) propped up their big banks using a mix of cheap capital and, in some extreme cases, nationalisation. The reasoning behind these “bailouts” was that if one important bank failed, it could very well take down the entire banking system, which is highly interconnected. Although it may protect against further financial crises in the short term, some experts argue that this policy creates moral hazard.<sup>22</sup> Banks (the agent) may take excessive risks if they believe they will be bailed out by the government (the principal) if they get into financial difficulty.

## Are Commission Rates for TPIs Excessive?

Following concern about the performance of the brokerage market, Ofgem has been developing a code of practice for non-domestic TPIs, potentially combined with an accreditation process and other measures to promote effective competition among TPIs. This process was recently put on hold.<sup>23</sup> Even if the process is resurrected, however, it is far from certain that it will be successful.

The question remains as to whether TPIs provide an effective service to customers at a reasonable price. To assess the performance of the sector, we:

- Review evidence on the average rate of commissions charged by TPIs in the non-domestic market; and
- Compare our findings to benchmarks for commission rates earned in other industries.

### Average TPI Commission Rates for Non-Domestics

Based on evidence cited in the CMA's report, we find that the average broker commission in the GB non-domestic electricity and gas market is about 2.6% of the total bill, as shown in Table 1.

Table 1 "Top Down" Estimate of Average Energy Brokerage Commission, 2015<sup>24</sup>

	Amount	Component	Source/Calculation
A	£16.1B	Big Six Energy Non-Domestic Revenues 2015	<i>Retail Energy Markets in 2016</i> , Ofgem, 3 August 2016, page 16
B	62%	Value-Weighted Market Share of Big Six	<i>Competition in British Business Energy Supply Markets</i> , Cornwall Energy, August 2015, pages 10, 13, and 16 <sup>25</sup>
C	£9.7B	Independent Non-Domestic Revenues 2015	= $(a/b) \cdot a$
D	30%	Broker Sales Channel Share for Big Six	<i>Appendix 16.1 of CMA (2016): Microbusinesses</i> , page 32.
E	50%	Broker Sales Channel Share for Independents	Conservative assumption based on previous source statement: "New suppliers rely heavily on TPIs as their main sales channel"
F	£4.8B	Big Six Broker Revenue	= $a \cdot d$
G	£4.8B	Independent Broker Revenue	= $c \cdot e$
H	£9.7B	Total Broker-Sourced Revenue	= $f+g$
I	£0.25B	Total Broker Commission	<i>Third Party Intermediaries in the Business and Industrial Energy Supply Market: Prospectus</i> , Cornwall Energy, September 2015, page 3.
	<b>2.6%</b>	<b>Broker Commission as a Percentage of Total Bill</b>	= $i/h$

Source: NERA Analysis. Note: Some values may not add due to rounding.

In practice, commission rates may vary according to customer size. It may be reasonable for a broker to charge a small- or medium-sized enterprise (SME) a higher commission rate as a percentage of the total bill than a large industrial customer. Many of the tasks required to make the sale and switch the customer will not vary with the size of the energy bill, and thus, the broker must charge a smaller customer a higher percentage of their bill to cover these fixed costs.

Market commentators have suggested that commission levels for SMEs are somewhat higher than the industry average and are between 0.5p/kWh and 0.7p/kWh for electricity, which corresponds to 5% to 7% of a 10p/kWh bill for electricity.<sup>26</sup>

### **Benchmarks from Other Industries**

We can look to other industries to determine whether the average commission rates for UK TPIs appear fair given the brokerage service offered in energy.

One starting point is to benchmark to similar energy markets abroad. In the US, one energy management firm quotes brokerage rates that range anywhere from 2 to 10 mils per kWh for electricity (A mil is a 10th of a cent or .001 USD). Assuming a 10cent/kWh energy charge, this commission is anywhere from 2% to 10% of the bill.<sup>27</sup> Our estimate of industry average commissions of 2.6% is at the lower end of this range, and our estimate of average commission rates for SME customers of 5% to 7% lies well within this range.

Brokers in other industries tend to charge commissions somewhat above our calculation of the industry average for energy brokers in GB.

In a survey of sales commissions in manufacturing, the average commission was about 8.8% of the value of the goods sold. The largest commissions reported were for scientific research equipment & suppliers: an average of nearly 14%. Brokers in the textile and industrial sectors earned 5.2% on average, whilst brokers in metals and raw materials earned 5.3%, forming the low end of those studied.<sup>28,29</sup>

Commissions for insurance products form a wide range. In one survey, the average across all lines was 10.5% of net premiums written.<sup>30</sup> Some insurance products, like fidelity & surety,<sup>31</sup> garner high commissions as a percentage of premium revenues (22% on average, the maximum of commissions studied), compared to others, like medical malpractice (4% on average, the minimum of commissions studied). Academics have argued that the range of commissions reflects differences in the value brokers provide as intermediaries. The ultimate level of commissions depends on factors such as the complexity of the risk, which enhances the importance of information gathering by the broker, and the profitability of the business placed by the broker.<sup>32</sup>

## Conclusion

Relative to the benchmarks we have identified, the industry average rates of commission for TPIs serving non-domestics in GB appear broadly reasonable. By the same token, examples of commission rates in the range of 20% to 30%, as identified by the CMA, appear excessive—both relative to industry average rates for TPIs in the UK non-domestic energy segment, and relative to comparator industries.

The extent of excessive charging by TPIs in the UK non-domestic energy market is unclear. The CMA did not address this question directly in its energy market investigation. However, some of the evidence it cited—for example, Big Six suppliers capping commission rates—suggests the problem may not be restricted to one or two isolated cases.

The supplier-pays model for remunerating intermediaries, with its lack of transparency and potential for distorting incentives, has contributed to poor practice in other industries where intermediaries play an important role. This same model may be causing similar problems among TPIs serving the non-domestic energy supply market in the UK, as indicated by the evidence cited in the CMA's energy investigation. Any business using a TPI ought to take a long, hard look at whose interests their TPI is serving—it may not be theirs, and, even if it is, customers may benefit from reconfiguring their use of TPIs to achieve efficient outcomes.

## Notes

- <sup>1</sup> *Energy Market Investigation*, CMA, 11 October 2016, <https://www.gov.uk/cma-cases/energy-market-investigation>.
- <sup>2</sup> *Appendix 16.1 of the Energy Market Investigation: Microbusinesses*, CMA, 11 October 2016, pages 31 to 32, <https://assets.publishing.service.gov.uk/media/576bcc4e5274a0da9000084/appendix-16-1-microbusiness-aec-finding-fr.pdf>. Henceforth "CMA (2016)".
- <sup>3</sup> Cornwall Energy, *Third Party Intermediaries in the Business and Industrial Energy Supply Market, Prospectus*, September 2015, page 3. Note that in *Appendix 16.1 of the Energy Market Investigation: Microbusinesses*, CMA cited an earlier estimate (£200 million) by Cornwall (page 32).
- <sup>4</sup> CMA (2016), pages 31 to 32.
- <sup>5</sup> *Quantitative Research into Non-Domestic Consumer Engagement in, and Experience of, the Energy Market*, The Research Perspective Ltd and Element Energy Ltd, December 18, 2013, page 30, <https://www.ofgem.gov.uk/ofgem-publications/85187/non-domquantfinalforpublication181213-pdf>.
- <sup>6</sup> *Appendix 16.1 of CMA (2016): Microbusinesses*, pages 32 to 33.
- <sup>7</sup> *Appendix 16.1 of CMA (2016): Microbusinesses*, pages 31 to 32.
- <sup>8</sup> *Ibid*, page 34.
- <sup>9</sup> *Ibid*, pages 40 to 41.
- <sup>10</sup> *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), BMG Research, 2015, page 53; *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), BMG Research, 2016, page 43.
- <sup>11</sup> *Appendix 16.1 of CMA (2016): Microbusinesses*, page 39.
- <sup>12</sup> *Ibid*, pages 36 to 38.
- <sup>13</sup> *Ibid*, page 39.
- <sup>14</sup> *Quarterly Energy Prices*, Department of Energy & Climate Change (DECC), 2016, page 23 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/532712/QEP\\_June\\_2016\\_Final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532712/QEP_June_2016_Final.pdf). We use 10p/kWh as a rough average electricity tariff, as this is the tariff charged to "medium" non-domestics. According to DECC (2016), the tariff can be as much as roughly 13p/kWh for "very small" non-domestics and as low as 9p/kWh for "extra large" non-domestics. Thus, for a "very small" customer, a 2p/kWh commission would be 15% of their bill, while for an "extra large" customer, the same commission would be 22% of their bill.
- <sup>15</sup> We assume the 2-3p/kWh commission quoted is for an electricity customer, although CMA (2016) does not specify so. If it were for a gas customer, where average prices are of the order of 2-3p/kWh, the commission would be equivalent to a 100% markup in some cases.
- <sup>16</sup> *Appendix 16.1 of the Energy Market Investigation: Microbusinesses*, page 39.
- <sup>17</sup> Y. Kotowitz, "Moral Hazard", *The New Palgrave Dictionary of Economics*, Second Edition, 2008.
- <sup>18</sup> Principal-agent problems can be traced to seminal works such as Marschak (1955), Arrow (1963), and Pauly (1968), and later works such as Mirrlees (1975), Holmström (1979), Shavell (1979), and Grossman and Hart (1983). See Luca Anderlini and Leonardo Felli, *The New Palgrave Dictionary of Economics*, Second Edition, 2008.
- <sup>19</sup> Kotowitz (2008).
- <sup>20</sup> Phillip Inman, "Banks Face Inquiry over Credit Insurance 'Racket'", *The Guardian*, 13 September 2005, <https://www.theguardian.com/money/2005/sep/13/debt.business>.
- <sup>21</sup> Tara Siegel Bernard, "M.I.T., N.Y.U. and Yale Are Sued over Retirement Plan Fees", *The New York Times*, 9 August 2016, <http://www.nytimes.com/2016/08/10/your-money/mit-nyu-yale-sued-4013b-retirement-plan-fees-tiaa-fidelity.html>.
- <sup>22</sup> Bailing Out Britain's Banks: A Timeline, *The Telegraph*, 19 January 2009, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4285063/Bail-out-Britains-banks-A-timeline.html>.
- <sup>23</sup> Priyanka Shrestha, "Brokers' Code of Practice Ditched... For Now", 1 Nov 2016, *Energy Live News*, <http://www.energylivenews.com/2016/11/01/brokers-code-of-practice-ditched-for-now>.
- <sup>24</sup> Note that for some input assumptions, the data we use is not for the 2015 period. We used data that may be as of a certain point in 2015, or from earlier or later periods as necessary if the data for 2015 was not available. We do not believe these values vary enough from period to period to have a significant impact on our estimate.
- <sup>25</sup> We calculate the value-weighted market share of the Big Six across the non-domestic electricity and gas market. To do this, we use the TWh quantity values in the Cornwall Energy report and then assume electricity's price per TWh is four times that of gas. We make this assumption based on the charts on pages 23 and 24 of *Quarterly Energy Prices*, DECC, 2016, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/532712/QEP\\_June\\_2016\\_Final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532712/QEP_June_2016_Final.pdf).
- <sup>26</sup> *Regulator Unpicks the Mystery of TPIs for Small Businesses*, Cornwall Energy, 27 March 2015.
- <sup>27</sup> *How Much Do Commercial Energy Brokers Get Paid?*, Solomon Energy, 2015, page 1, <http://www.solomonenergy.com/blog/wp-content/uploads/2015/07/2015-07-23-How-Much-Do-Brokers-Get-Paid.pdf>.
- <sup>28</sup> Manufacturers' Agents National Association, Directory of Manufacturers' Agents, 1982 via Table 1 of Bernheim and Whinston, "Common marketing agency as a device for facilitating collusion", *Rand Journal of Economics*, Summer 1985.
- <sup>29</sup> Bernheim and Whinston (1985) reported highest and lowest percentages for broker commissions in selected manufacturing industries. We use the midpoint as our average.
- <sup>30</sup> "Net premiums written" is the "sum of premiums written by an insurance company over the course of a period of time, less premiums ceded to reinsurance companies, plus any reinsurance assumed. Net premiums written represents how much of the premiums the company gets to keep for assuming risk." See: "Net Premiums Written", Investopedia, <http://www.investopedia.com/terms/n/net-premiums-written.asp>.
- <sup>31</sup> Fidelity insurance is protection bought by a principal to ensure an agent performs on their obligation or contract. Fidelity insurance protects against bad behaviour by employees, like theft. For more information, see: "Commercial Surety, Fidelity, and Contract Surety Bonds", The Hartford, <https://www.thehartford.com/bonds>.
- <sup>32</sup> Cummins and Doherty, "The Economics of Insurance Intermediaries", *The Journal of Risk and Insurance*, 2006, Vol. 73, No. 3, pages 374-376.

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