AS AT 07.34 on 14 May 2018

SLIDE 1

Thank you for the invitation to present at this inaugural Consumer Law Conference.

I'm not going to discuss the consumer law today – rather, I'm going to discuss competition but not competition law. Just competition.

My thoughts are written up in a paper I've prepared for this conference. It's titled *Competition, Neo-paternalism and the Nonsumer Uprising*. I'll make it available to the conference organisers to distribute and I'll also put it up on our website.

Competition has been the dominant micro-economic policy narrative of last 30 years

Overall, competition policy has been very successful in raising our national productivity and prosperity.

But I'll be arguing that in some markets, competition hasn't worked as expected.

But despite these shortcomings, the merits of competition in these markets has never really been questioned.

Instead, any **assessment of these markets has typically been limited to a discussion about the inadequacies of regulation rather than effectiveness of competition**.

For the last 25 years, ever since the Hilmer Review, serious questions about the effectiveness of competition have sat in a policy blind spot.

In a paper I prepared for the ACCC's Consumer Congress a couple of months ago, I found myself questioning: What exactly ***is*** competition?

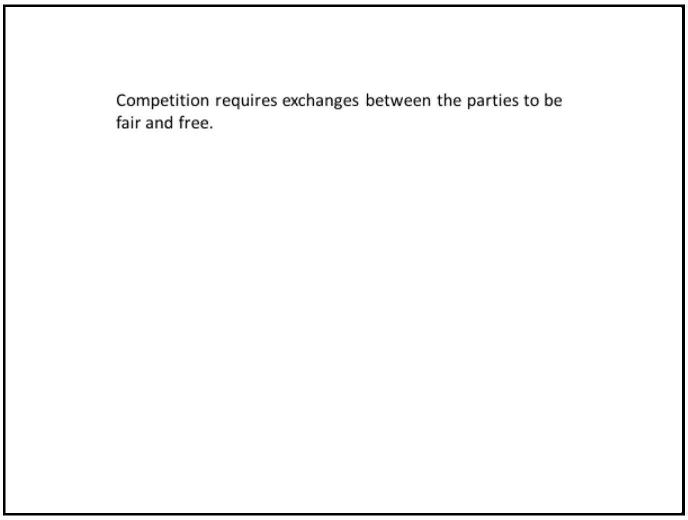
We talk about it a great deal, but what exactly does it mean? So I went looking for a definition.

Surprisingly, I couldn't find a definition of competition in any of the major policy documents (particularly as they relate to the reform of the retail energy market).

In fact, the last time it was defined was in the Hilmer Review – and that was back in 1993.

By today's standards, that definition doesn't quite cut it.

SLIDE 2



My paper therefore proposes a definition of its own.

My definition encompasses the Hilmer Review's definition but it is more precise, which, I believe, makes it more meaningful in terms of assessing today's markets.

For today's purpose, the important point that I need to stress is that competition needs to be **fair and free.**

That's hardly a radical statement. But as I'll show shortly, it has far-reaching consequences.

In the context of a definition for competition, "fair" means that goods and services must be exchanged in a way that consumers expect or are led to believe.

(This definition sits comfortably with the definition of unfair in s.24 of the Australian Consumer Law.)

I appreciate there are other conceptualisations of fairness – for example,
(1) supporting vulnerable customers to ensure they are not deprived of access to essential services; or even more broadly (2) providing for an equality of outcomes (or at least, opportunities) for everybody.

These alternative definitions of fairness are important considerations in a broader policy context, but not they're not necessary to include in the definition of competition.

However, my paper is not focused on fairness, rather, my real interest is in the requirement that competition relies on **free** exchange.

Competition cannot exist in the absence of free exchange

SLIDE 3

In this context, I propose that "free exchange" means:

> *The exchange must be pursued voluntarily and free of any coercive influence being brought to bear of any of the parties to the exchange.*

Or alternatively stated:

Free exchange implies customers can 'walk away' from a market without making a purchase if they are dissatisfied with the prices or services on offer.

Why is this so important?

It's important because of what competition is there to do.

I'll explain what "competition is there to do" in a moment

But first . . .

SLIDE 4

Competition requires exchanges between the parties to be fair and free.

Free exchange implies customers can 'walk away' from a market without making a purchase if they are dissatisfied with the prices or services on offer.

Customers are not free to walk away from various markets despite those markets having been opened to competition. Customers' ongoing participation in these markets is involuntary and largely inelastic.

Let me observe that there are a number of markets where service provision is supposedly subject to competition, but in which customers are not free to walk away.

The market I am most familiar with is the retail energy market. I use this market as the main example in my paper.

You can probably think of various others markets where customers are not really free to walk away: banking , superannuation, various insurances, maybe fuel – and there may be others.

These days, all these markets are considered to be "competitive" markets with multiple suppliers making many offers and working hard to attract customers – but even though there's a great deal of choice, there's one choice customers do not have. Customers are not free to walk away from these markets.

In other words, customers' participation in these markets is involuntary and it's largely inelastic.

By inelastic, I mean: customers don't really get to choose how much they consume.

Whether, for example, electricity prices go up or down, doesn't affect how much electricity customers consume.

In the end, they use what they need; and what they need is what they need. It doesn't depend on price.

So over the past 25 years, we have introduced competition into markets where customers can't choose whether they participate or not. And often, they can't even choose how much they consume.

That’s why I’ve called these markets…

SLIDE 5

> Competition requires exchanges between the parties to be fair and free.
>
> Free exchange implies customers can ‘walk away’ from a market without making a purchase if they are dissatisfied with the prices or services on offer.
>
> Customers are not free to walk away from various markets despite those markets having been opened to competition. Customers’ ongoing participation in these markets is involuntary and largely inelastic.
>
> In these ‘**nonsumer**’ markets, there is no guarantee the competitive process of discovery will work as expected or produce an efficient outcome.

…**“nonsumer” markets.**

In a consumer market, you get to choose whether you participate or not; and you get to choose how much you consume (and when you consume it – if at all).

In nonsumer markets, customers don’t have those choices.

The set of choices available to customers in a nonsumer market is *greatly* reduced compared to a regular consumer market.

And most importantly, in nonsumer markets, customers can’t exercise the ultimate right they have in regular consumer markets – namely, the ability to walk away without making a purchase.

In which case, **the exchange is not free. It’s being made under a form of duress stemming from fear of losing access to that service**.

Without free exchange the competitive process is greatly undermined.

Why is that?

The answer comes from the Austrian School of philosophy and economics which describes competition as a process of discovery.

Consumers discover what suppliers have to offer.

Suppliers discover what customers value and what they're prepared to pay for different products. Suppliers also discover what it takes for a customer to walk away and not make a purchase.

In other words, **competition allows suppliers to discover customers' *willingness to pay* for their goods of services**.

Competition allows suppliers to discover how much customers value the things they have to sell.

In return, customers discover what it costs suppliers to produce and sell those goods and services.

But if an exchange between a supplier and customer is *not* made freely – if it is made under duress – then the information discovered though the competitive process is flawed.

And potentially, highly flawed.

For example: A customer with a metaphorical gun held to his head, is likely to pay more for an object than might otherwise be the case; and vice versa for a seller.

Likewise, if a customer cannot walk away from a market when the price is too high (or the service is poor) then the competitive discovery process can't work properly. Suppliers can't tell how much customers value the things they have to sell. In which case, competition cannot work properly.

This is a very confronting conclusion: In nonsumer markets, competition cannot work properly because exchanges are not made freely.

If I return to my example of the retail energy market…

In Victoria, we have 27 active energy retailers, hundreds of offers to choose from, lots of marketing and many customers switching between different retailers every day.

I imagine most people will scoff at the suggestion that this market might not be competitive.

But this way of thinking confuses two related but different concepts: Competition and Contestability.

They are <u>not</u> the same.

The retail energy market is very definitely contestable but…

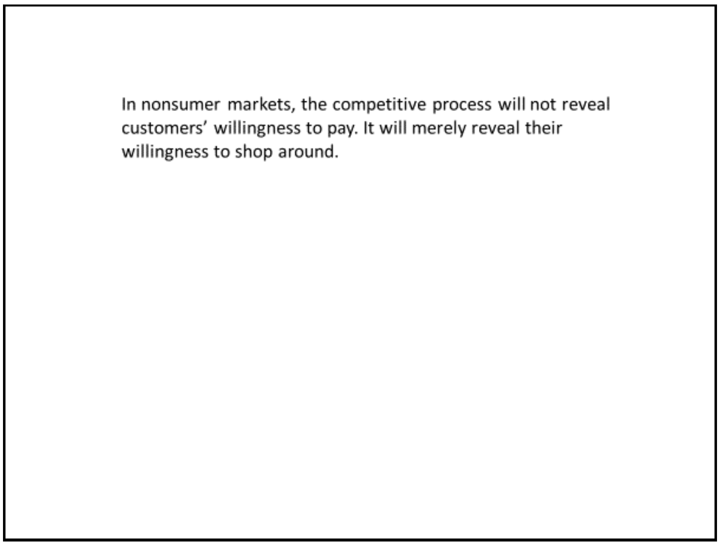
Competition cannot work as a process of discovery in this market because customers are not making purchases freely. They are buying electricity because they have no other choice.

Energy customers have that metaphorical gun held to their heads when buying electricity.

In which case, the competitive process cannot reveal how much customers really value electricity – that is, how much they're prepared to pay for different amounts; and at what price they would be prepared to walk away without making a purchase.

Competition in nonsumer markets (like the electricity market) cannot reveal customer's willingness to pay for these nonsumer services.

SLIDE 6



All the competitive process can achieve in nonsumer markets is to reveal customers <u>willingness to shop around</u> – because that's the only choice customers have available to them in these markets.

Customers can choose to shop around, but they can't choose to buy less and they certainly can't choose not to buy at all.

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The title of my paper refers to **neo-paternalism**.

Before I explain what I mean by that term, let me quickly define paternalism. Paternalism can be defined as:

> *policies by people in authority to restrict the freedom and responsibilities of other people in the supposed interest of those other people.*

Economists tend to see paternalism as the antithesis of competition.

Why?

Because paternalism interferes with customers' consumption decisions by limiting the choices available to them.

It interferes with customers' decisions about what they buy, when they buy it, how much they buy and how much they pay.

This undermines the competitive process of discovery and explains why economists tend to be particularly hostile to paternalistic policies.

So what do I mean by *neo-paternalism* ?

If paternalism limits or denies people the right *to* choose, then **neo-paternalism denies customers the right *<u>not</u>* to choose**.

I suggest that by introducing competition into markets where customers cannot freely enter an exchange, the market reformers acted neo-paternalistically.

By introducing competition into nonsumer markets, neo-paternalism forced customers into a market by denying them the right not to participate.

Why does this matter?

It matters because it forces customers to shop around for a product they have no option but to buy. This is not a trivial matter.

Competition forces customers in nonsumer markets to reveal their willingness to shop around to suppliers.

And I need to emphasise again: Willingness to shop around is not the same as willingness to pay.

Willingness to pay is all about how much you are prepared to pay at different prices; and at what price you'll just walk away.

Willingness to shop around is only about how much you will look around at different offers before making a purchase.

In regular consumer markets, customers shop around *in order to* proceed with a purchase.

You shop around to buy clothes; and if you don't find clothes you like at a price you're prepared to pay, then you walk away and don't buy clothes (or you buyer fewer clothes than you were planning).

In regular consumer markets, shopping around is an input into making a purchase. Customers shop around so that they can ultimately make a purchase. Shopping around is on the critical path to making a purchase.

In other words, **in regular consumer markets there is a causal relationship between shopping around and the eventual decision to make a purchase**.

In nonsumer markets, there is no such causal relationship between shopping around and making a purchase.

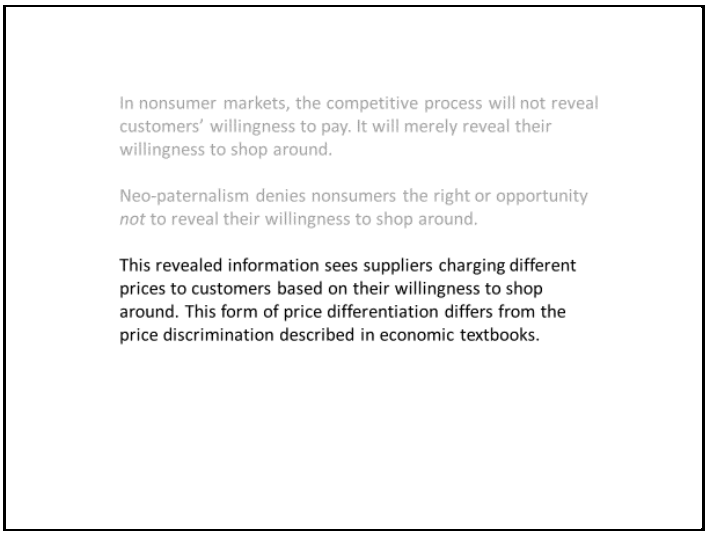
Whether you shop around or not for, say, your electricity, makes no difference as to how much you're going to buy. You're going to buy electricity one way or another; and you're going to buy the same amount of electricity one way or another.

The only decision open to you is whether you shop around a little, a lot, or not at all.

So **in nonsumer markets competition is forcing customers to reveal their willingness to shop around**.

You can't hide your willingness to shop around from the market because you can't hide yourself from the market – in other words, you can't choose not to make a purchase.

SLIDE 8



Now once customers have revealed this information about themselves – because they have no option but to reveal it – suppliers can. and will, take commercial advantage of that information. That's the perfectly rational thing for them to do.

Suppliers will start to charge different prices to different customers.

If you're not particularly inclined to shop around, you're going to pay more than someone who is.

If you don't want to shop around at all, you're going to get screwed.

I suspect most of you are thinking: So what? That's what happens in every market. *Caveat emptor*, right?

Well, that's right, but remember, in those 'regular' markets you have the choice of buying less or even walking away from the market if prices are too high.

If theatre tickets become too expensive, then you'll buy fewer tickets or you might go to the cinema instead.

You are free not to go to the theatre.

But if electricity prices are too high, or the banks charge excessive fees or superannuation commissions are too high – well, you can't walk away from these markets in protest.

All you can do is shop around and switch, but your willingness to shop around is visible to suppliers.

After a few years, the energy companies or banks or super funds will have begun to profile you. They'll know how much they can push you around before you'll start shopping around.

And if you think they're not profiling you, then think again. This is no conspiracy theory. I dare any of the major energy companies or banks to deny they profile their customers.

And the point is this…

The better they become at profiling customers, the wider the spread of prices – as supplier become better at exploiting customers according to their willingness to shop around.

But that's not all.

If **<u>all</u>** suppliers are profiling – or even if just the big players in each market are doing it – then the general level of prices will also increase with time.

This explains why the ACCC and the Thwaites review in Victoria have come out expressing deep concerns about retail energy prices. This is why the ACCC has expressed concerns about the interest rates paid by different groups of bank customers.

In my paper, I call this customer profiling and growing price spread "price differentiation".

And for any economists in the room, my concept of price differentiation is very different from theories of price discrimination – but you'll need to read my paper for a fuller explanation of this difference.

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In nonsumer markets, the competitive process will not reveal customers' willingness to pay. It will merely reveal their willingness to shop around.

Neo-paternalism denies nonsumers the right or opportunity *not* to reveal their willingness to shop around.

This revealed information sees retailers charging different prices to customers based on their willingness to shop around. This form of price differentiation differs from the price discrimination described in economic textbooks.

Price differentiation represents a wealth transfer between customers based only on their willingness to shop around. It has nothing to do with efficiency or equity.

So what does this customer profiling and price differentiation do?

Well, it sees some customers pay more because they are less willing to shop around; and some customers pay less because they are more willing to shop around.

In other words, one group of customers is, in effect, cross subsidising the lower prices being paid by another group of customers.

Andy Vesey, the CEO of AGL, referred to the higher prices paid by the first group of customers as a "loyalty tax".

And that is exactly what it is. It is a tax paid by customers who have a low willingness to shop.

In nonsumer markets (like electricity), competition induces a tax and transfer system from one group of customers to another group of customers.

Wealth is being taken from one section of the community and being given to another section of the community.

Now this transfer isn't happening because one group is more in need, or more deserving or more disadvantaged than the other group.

It is not occurring because of impairment, ill-health, financial distress or unemployment.

Helping people in need is a noble and enduring reason for operating a tax and transfer system.

But in nonsumer markets, the transfer is only happening on the basis of customers' willingness to shop around.

Has there ever been a more trivial reason for operating a tax and transfer system than because of someone's willingness to shop around?

And by the way, who usually operates tax and transfer systems in pursuit of noble and enduring policy goals? Governments.

Governments who are accountable to the people for the design and administration of these tax and transfer systems.

And who is responsible for designing and administering tax and transfer systems in nonsumer markets?

Vested interests.

Vested interests with no accountability to anyone but their shareholders.

In nonsumer markets, competition has resulted in tax and transfer systems on a grand scale operated by vested interests solely in the pursuit of their own interests – namely, profits, market share or both.

There is no social benefit that results from these transfers.

The economy does not operate more efficiently in terms of, say, more customers consuming more electricity because of this price differentiation.

The same amount of electricity will be consumed one way or another.

And there's no equity or distributional benefit across the community – in terms of who receives the benefits of the lower prices.

There is <u>no</u> evidence to suggest that it is only customers in financial need who will shop around. Indeed, there's good reason to believe the opposite is true.

Willingness to shop around has nothing to do with willingness to pay, let alone capacity to pay.

SLIDE 10

With the passage of time, suppliers become more adept at price differentiating. This places an increasing burden on nonsumers to shop around even more.

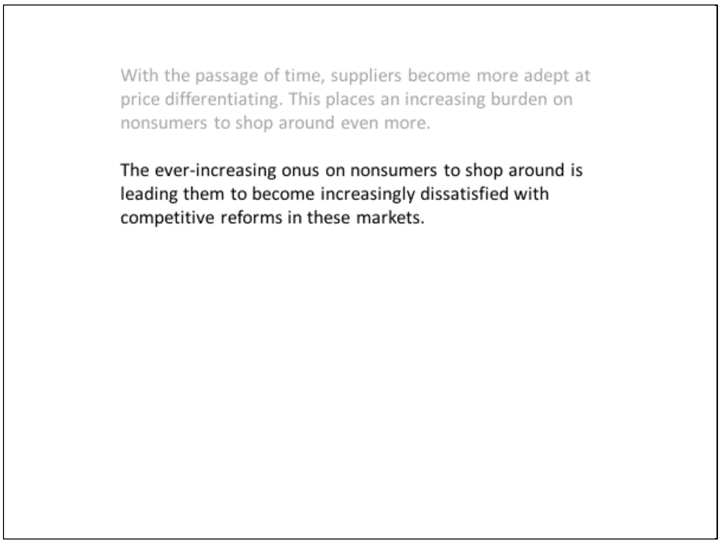
I already mentioned how, with the passage of time, the spread of prices charged to different types of customers will widen – based on their willingness to shop around.

This places an ever-growing burden on customers to shop around; or face the risk of being exploited through higher prices.

Contributing to superannuation or buying electricity, or even fuel, is not like buying movie tickets. You can always choose not to go to the movies or at last go less often. You don’t have that choice with electricity or superannuation.

It is this lack of choice that energy retailers, banks and super-funds tax if you don’t shop around, over-and-over-and-over again.

SLIDE 11



But shopping around takes time and effort.

My wife and I recently consolidated our banking arrangements.

It took weeks, multiple meetings, endless paperwork and reams of terms and conditions to read through.

And then there's the time it takes to shop around and negotiate a reasonable deal.

We know from survey data that, even though it's relatively easy to switch energy retailer, many customers don't switch.

In fact, about 50 per cent haven't switched in 5 years.

I am prepared to bet that most of these customers are paying well above the odds for their electricity and gas.

Some analysis recently done in Victoria – the state with apparently the 'most competitive retail energy market' – showed that customers could typically save around $200-300 if they shopped around.

But they don't shop around and then they get exploited … and then they get angry and then they get angrier.

So why don't they just shop around and switch you ask?

Well, there are a few reasons: Obviously it takes time and it's boring.

We also know that they don't trust the market and they often expect that any benefits they gain from switching will quickly evaporate anyway – in which case, they would need to start all over again.

And that's the crucial point.

Customers in these markets are angry about having to switch because the only reason they need to switch is to avoid being exploited.

They are angered by the flawed logic of having to shop around. It's an argument built around a logical fallacy known as "begging the question". It's a line of logic that states, "Shop around and you'll get a lower price because if you don't shop around you'll pay more." It's a totally self-referential argument.

The electricity customers buy doesn't get any better if they switch. The service they get from switching to another retailer probably doesn't change very much. It's all the same no matter what they do.

In which case, the only reason for switching is to avoid getting exploited for your disinterest in shopping around.

You're not saving money by switching. You're avoiding being exploited.

And you need to keep doing it over and over and over again – or before long, you'll be paying higher prices again.

No wonder people are getting angry and it's that anger that pushes the polity to respond with various reviews, inquiries, royal commissions and regulatory interventions.

When was the last time we had a parliamentary inquiry into the price of theatre tickets or a royal commission into the conduct of café barristas?

Nearly every, if not every, major inquiry we have had in this country is into a market that has elements of being a nonsumer market -- that is, markets that are involuntary and largely inelastic; markets that lack free exchange.

That's because in other markets, if you're getting screwed, you can just walk away.

In nonsumer markets you don't have that option. You just need to keep shopping around, over and over and over again.

* * *

And there's another way to think about this situation.

A moment ago, I said: The only reason for switching is to avoid being exploited

Now think about the inverse of that statement.

The inverse of that statement is: If you don't shop around and switch, it's your fault if you're exploited.

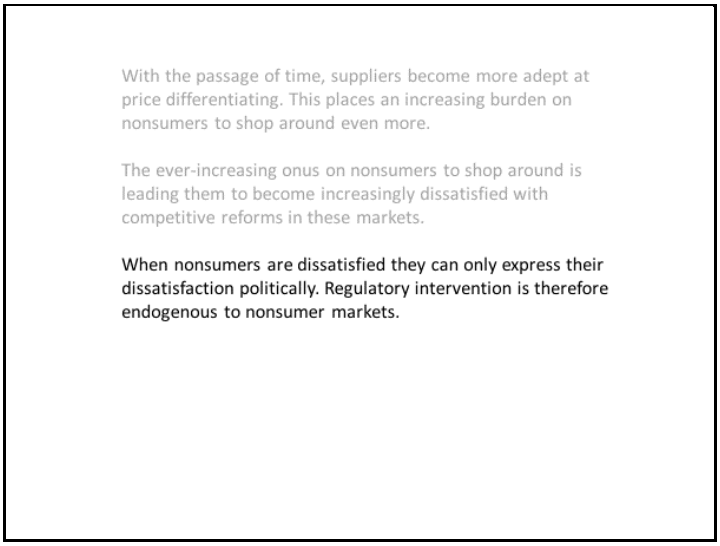
That's why I get angry when I see my fellow regulators telling customers in nonsumer markets that the answer to their dissatisfaction is to just shop around.

That's the same as telling them that it's their fault for paying too much.

I can't accept that position.

It's not nonsumers' fault that they are trapped in a nonsumer market. They're trapped and that's why they get angry.

SLIDE 12



In other markets, customers who are angry can just walk away.

If they're annoyed and get fed up, they can just avoid making a purchase and go and spend their money elsewhere.

But they don't have that option in nonsumer markets.

So what do they do?

They complain.

Nonsumers' only option is to vent their dissatisfaction to anyone who will listen. This might include friends, neighbours, radio comperes or their political representatives. But only the latter have an obligation to listen.

And that's why we're seeing so much political interest in these markets.

And importantly, we will continue to see that political interest.

It might wax and wane, but it will always be there.

That's why **political interest in nonsumer markets <u>is the inevitable and unavoidable consequence</u> of introducing competition into these markets.**

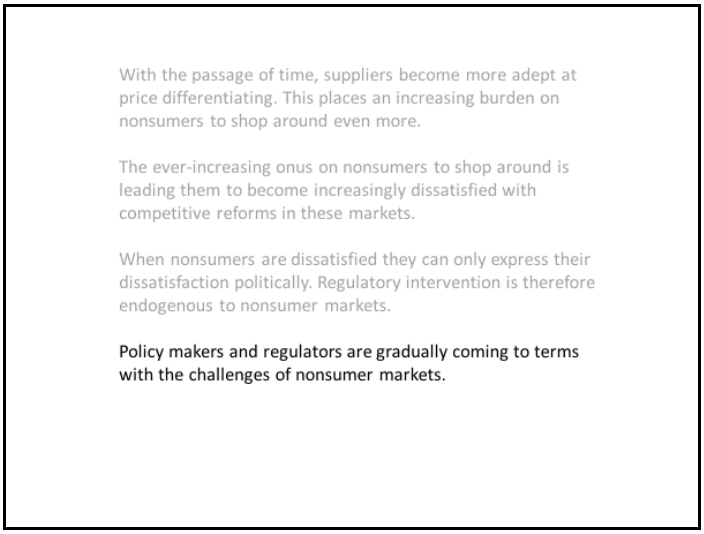
You know the old saying about "bad politics getting in the way of good economics"?

Well, that's a load of rubbish in these markets.

In nonsumer markets, political interest <u>**is**</u> part of the market.

Political and regulatory interest comes <u>**from**</u> the market. It is *not* something that happens <u>**to**</u> the market.

SLIDE 13



I would suggest that for the last 25 years, since the advent of competition policy, the regulatory community has been in denial about the reality of competition in nonsumer markets.

The usual response to customer dissatisfaction has just been to exhort customers to shop around.

As you may appreciate by now, I am highly critical of that response.

I see it as blaming customers for being exploited in a market from which they cannot escape.

Fortunately, others are now also starting to see a problem with these markets.

In fact, just a week-or-two ago, Rod Sims referred to the outcomes from the competitive reforms in the retail energy market as a "great disappointment to everybody".

SLIDE 14

With the passage of time, suppliers become more adept at price differentiating. This places an increasing burden on nonsumers to shop around even more.

The ever-increasing onus on nonsumers to shop around is leading them to become increasingly dissatisfied with competitive reforms in these markets.

When nonsumers are dissatisfied they can only express their dissatisfaction politically. Regulatory intervention is therefore endogenous to nonsumer markets.

Policy makers and regulators are gradually coming to terms with the challenges of nonsumer markets.

It remains an open to see whether technical innovations or new service models can circumvent the shortcomings of nonsumer markets.

Innovation may help.

Just last week, CHOICE launched a new and very clever offer to assist customers avoid being exploited by electricity suppliers.

And the Victorian government launched a Power Saving Bonus to encourage customers to visit the government's comparator website as a trusted source of information about the market.

We'll need to see how these initiatives work and how energy retailers respond.

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I expect the ideas I've express in my paper won't be very popular with many of my economic colleagues or those who are wedded to competition as a self-evidently beneficial mechanism of social and economic organisation.

But I believe this is the most important paper I have ever written.

My hope is that my paper begins the national discussion that has been missing for 25 years – namely, a critical and honest discussion about the limits of competition, and the consequences of introducing competition in nonsumer markets.

Once we recognise those shortcomings, then we, as a regulatory community, need to respond to those limitations openly and imaginatively.

— END —