# Competition, Neo-paternalism and the Nonsumer uprising

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* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures.

*"Choice can either be a great benefit, a kind of gift,*
*or instead, an immense burden, a kind of curse."*

Cass R. Sunstein[1]

[1] Cass R. Sunstein (2017) *Requiring choice is a form of paternalism.* Journal of Behavioural Economics for Policy, Vol. 1, No. 1, 11-14.

## OVERVIEW

**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.**

**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 suppliers 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.**

**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.**

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## 1. INTRODUCTION

Before I begin, I must share a confession. Despite this being a conference dedicated to an exploration of the Australian Consumer Law, I have no intention of discussing that body of law. Indeed, I have no expertise whatsoever in that area. Instead, I want to discuss ‘competition’ — not competition law, just competition.

Competition has arguably been the most compelling driver of economic policy in the past 70 years. During that time, other policy imperatives have come and gone in fairly short order, but competition has now been a driving force in policy decision-making for a quarter of a century.

It is now 25 years since competition policy became the headlights that helped us see our way down the highway of regulatory reform. The times that followed the Hilmer Review in 1993 were heady days indeed. The objective of competition served as a powerful headlight brightly illuminating the way forward; and the way forward was clear. Commercialise. Corporatise. Rationalise. Privatise. Liberalise. These were incredibly powerful ideas. They drove a wave of reform possibly unmatched in our economic history. Today’s economy is vastly more flexible and efficient than ever before. It is an economy that has ridden the vicissitudes of global financial turmoil with an ease no-one could have foreseen and we have great wealth to share if we choose to do so.

Competition policy has been extraordinarily effective, but despite this, there is a growing sense of unease in the community; and consequently, there is a growing sense of unease in our polity.

There’s nothing more the media like more than a salacious story about a customer who has been poorly treated by their energy retailer. Phony insurance products and the price of health insurance, are sure to always get a good run on television. Shonky services and misleading sales in the telecommunication industry, well everyone has a story they can share about that. And, of course, we now have an entire royal commission dedicated to misconduct in the financial services sector.

Whenever these stories run in the media, they are sure to be triangulated with a victim, a villain and an umpire all given their 15 seconds of fame. First, the victim: a forlorn customer unsure how or why this misfortune has befallen them. Second, the villain: the penitent service provider sorry for the injustice they have caused, and even sorrier for having been caught. Finally, the regulator who through pursed lips threatens to investigate, while at the same time reminding customers they need to shop around.

And there it is in a nutshell: Competition policy means customers need to shop around. The introduction of competition into previously protected markets meant customers would now need to shop around.

## 2. THE COMPETITION AGENDA

In the 1980s, economics became the lingua franca of policy and politics. At first it was all about macro-economics. Remember our endless fascination with trade deficits, the current account and J-curves? By the 1990s, attention had turned to the micro-economic agenda. At its centre lay competition policy and the desire to make our industries, and our entire economy, more competitive. Competition would now reach into areas of the economy previously shielded from the rigours of market-imposed discipline.

Looking through various seminal documents that established the competition agenda in Australia, it quickly becomes evident that none contain a definition for the term 'competition'.[2] Indeed, the last time it appears to have been defined was in the original report from the inquiry into national competition policy chaired by Fred Hilmer in 1993. That report offered the following definition:

> *"Competition may be defined as the "striving or potential striving of two or more persons or organisations against one another for the same or related objects"."* (p.2)

This definition appears to have come from an Oxford University PhD thesis in the mid-1970s.[3] Interestingly, the definition's original author continues with the observation:

> *"*[This] *common-sense idea of competition is imprecise and open-ended insofar as its general meaning specifies nothing about … the nature of the objectives of the competitive pursuit* [or] *the setting in which competitive striving takes place…"*[4]

Despite the equivocations of its original author, this definition of competition has been lying, dormant and unquestioned, at the centre of our economic policy culture

[2] Ben-David, Ron (2018) *The forgotten question about competition*. National Consumer Congress (15 March)

[3] The Hilmer Review footnotes the source of this definition as: Dennis F C, *Competition in the History of Economic Thought* (1977). Further investigation suggests this book arose from a PhD thesis by Kenneth G Dennis who explores the semantic evolution of the term 'competition'.

[4] The full reference reads: "the common-sense idea of competition is imprecise and open-ended insofar as its general meaning specifies nothing about (a) the nature of the objectives of competitive pursuit, (b) the setting in which competitive striving takes place, (c) the participants and their grouping into competitive "units," and (d) the strategies and patterns of conduct followed."

for the last quarter of a century. For 25 years, market competition and competitiveness have been upheld as self-evident truths — axioms of social organisation requiring no further exploration or justification.

As far as the economics profession was concerned, it had delivered this national policy imperative with its focus on the efficient deployment of society's resources. Previously sheltered and mollycoddled sectors were now exposed to the ruthless discipline of having to prove their worth to existing and potential customers. The economics profession openly acknowledged there would be 'winners and losers' from this new agenda but matters of equity were viewed as lying beyond the scope of their economic responsibilities. Rather, this collateral was left to others to address. Dealing with these concerns was portrayed as a value judgement; a judgement from which the economic profession simply excused itself. It was argued that economics was values-free. Competition policy was values free. Empowering customers to shop around was values free.

Occasionally, a competitive market did not operate as expected, or the community or polity were dissatisfied with the outcomes being experienced. In those instances the economic profession was sure to keep policy makers attention squarely focussed on correcting market failures rather than intervening directly in the operation of market. How many reports by economic bodies of inquiry open with a lengthy exposition on the nature of market failure and the ills of regulation?

In pursuing this approach, the economic-policy class constructed a narrative that, in effect, circled the wagons around the policy commitment to 'competition'. This powerful barrier has ensured competition's meaning and its application have been shielded from questioning for 25 years.

At the same time, the consumer policy classes, many of whom were originally hostile towards competition policy, eventually surrendered their antipathy as the merits of competition became apparent over the years. Instead, they redoubled their efforts to establish basic consumer protections, most obviously in the Australian Consumer Law. Ironically, doing so has further shielded competition from closer scrutiny.

By providing a safety net for consumers, the consumer law has, in effect, accepted the axiomatic nature of competition. Alternatively stated, by providing redress for customers, the consumer law acknowledges — and inherently accepts — the potential misalignment of interests that competition *may* produce. Where competition goes wrong, the consumer law is left to address potential sources of harm. In so doing, the consumer law has shielded competition policy from the closer policy scrutiny it requires.

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Economic policy and consumer policy have combined somewhat peculiarly to create a policy and regulatory blind spot. Competition and consumer policies have conspired, probably unwittingly, to ensure some questions remain permanently out of sight.  Their combined effect has blinded us to questions about the efficacy of competition. Indeed, they have blinded us to questions about the very meaning of competition.

This paper seeks to bring those questions back into sight.

The objective of doing so is not to undermine 25 years of largely successful policy. Nor is it to undermine consumer confidence in market-based service delivery. Rather, this paper observes there is *already* diminishing consumer confidence in a range of markets; and this diminishing confidence has led to increased government interest and intervention. The paper seeks to understand the relationship between competition and declining consumer confidence in these markets. While the paper draws many of its examples from the retail energy market, these examples will be echoed in other markets. These markets might include: telecommunications, life insurance, health insurance, fuel, banking, superannuation and other financial services.  In the future it may also include the NDIS.[5]

[5] National Disability Insurance Scheme

## 3. DEFINING COMPETITION

Before returning to the meaning of competition, it is necessary to introduce two other critically linked, but quite different, concepts. While these two concepts exist independently, they usually get mashed into any discussion about competition. These concepts are: contestability and efficiency.

Contestability refers to the existence of rival suppliers — or even just *potential* rivals — seeking to win custom. Contestability requires that there be low barrier for new entrants wishing to operate in a market and challenge incumbent suppliers.

From a consumer perspective, the benefit of contestability comes from the choice it enables, either in the form of choice of supplier or choice of service; or both. As Ian Harper and his colleagues noted in their seminal report:

> *"Having more choices open to us, along with greater capacity to exercise informed choice, improves our lives, individually as well as communally."* *(p.20)*

This powerful idea impelled the Harper review to advocate strongly for enabling choice in sectors such as human services. While the review cautioned against meaningless choice, it nevertheless found that choice was a worthwhile outcome in its own right.[6] Contestability is the vehicle for providing choice to customers.

The benefit of that choice has sometimes been measured by the extent to which customers are observed switching between alternative suppliers.[7] That approach is not without its detractors.[8]

The second standalone concept that needs to be distinguished before turning to a discussion about the meaning of competition is the economic ideal of efficiency — or more correctly stated, the ideal of economic efficiency. There are whole books and careers dedicated to defining economic efficiency but it eventually boils down to one set of conditions, namely: What is made is made at the lowest sustainable cost; and

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[6] Harper Review (p.24) "On the other hand, choice is not about having unlimited options or facing a bewildering array of possibilities. It is about having our needs and preferences met easily and affordably, in a timely fashion, and at a place and time of our choosing…"

[7] See various Australian Energy Market Commission reports on Retail Competition

[8] Ben-David, Ron (2015) *If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?* NEM Future Forum 2015 (25 June 2015)

what is made is what is needed such that no-one can be made better-off without someone else being made worse-off. Importantly, this definition is agnostic to the distribution of income or wealth, or the goods and services produced. This is the basis for the earlier observation that economists typically view matters of equity as lying beyond the scope of their economic responsibilities.

Whereas contestability is a means for achieving choice, efficiency is an end-state. Market efficiency is an attribute that helps describe an outcome. Alternatively, this can be stated as: the purpose of contestability is to enable choice while the purpose of efficiency is to reach an outcome where there is no wasted opportunity.

There is no self-evident or direct link between the concepts contestability and efficiency. Competition bridges this gap. That said, there is no single, universally accepted definition of competition.

The neo-classical school in economics tends to view competition as a state that is defined by its contestability and efficiency. This somewhat unhelpfully embeds the notions of contestability and efficiency within the definition of competition; or more precisely, it is embedded within an abstract ideal known as 'perfect competition'.[9] Doing so makes it unclear how competition can be defined in isolation from the concepts of contestability and efficiency. Indeed, it is unclear how competition can be defined as a distinct idea from the neo-classical ideal of 'perfect competition'. Given the predominance of neo-classically trained economists in policy circles since the 1970s, it is perhaps no wonder that competition has not been defined in any of the major policy documents since the Hilmer review 25 years ago.

The so-called, 'Austrian school' of economics provides a more independent conception of competition that does not rely on contestability and efficiency. This body of thought views competition as a mechanism of discovery. That is, competition reveals consumers' preferences.[10] This in turn drives profit-seeking producers to seek to satisfy those preferences more effectively than their rivals.

[9] Perfect competition (or a perfectly competitive equilibrium) is a synthetic ideal created in order to provide a basis against which the non-perfect markets observed in the 'real world' can be assessed. Kenneth Dennis, the author of the definition adopted in the Hilmer review, refers to perfect competition as a "heuristic fiction".
[10] Alternatively stated, competition allows suppliers to locate the demand curve they face (in aggregate and potentially for individual customers) — its slope and the factors that will cause it to shift.

In this way, competition fills the space between contestability and efficiency. Contestability enables choice. Competition takes this choice and uses it to reveal customers' preferences and drive producers to satisfy those preferences. In the absence of any distortions (or market failures) this competition results in an outcome that is efficient.

The potential of competition to drive efficient outcomes is something on which all the major schools of economics agree.

But note, although the above discussion outlines the *role* competition, it does not offer a definition of competition. While the notions of contestability and efficiency have been defined, no definition has yet been proffered for competition — other than the definition adopted in the Hilmer review over which even its own author equivocated. Moreover, with the benefit of 25 years of experience with competition policy, the definition provided in the Hilmer report appears to be somewhat lacking.

This paper therefore proposes the following more deliberate definition of competition.

> ***Market competition is an implicit or explicit process of bidding and acceptance of bids that results (or seeks to result) in the free, fair and non-altruistic exchange of a scarce object.***[11]

This definition is consistent with the definition adopted in the Hilmer review, but it is more precise and more encompassing of our experience with markets. As suggested shortly, this precision provides insights into why competition might be failing to meet expectations in some consumer markets.

It is helpful to explore some of the terms in this proposed definition in more detail.

- While the reference to **"implicit or explicit"** is somewhat tautological, it is included to emphasise that the process leading to the exchange at an agreed price often may not be observable (compared to, say, an open outcry auction which is readily observable).

[11] To this definition could be added the following necessary minimum condition: **The scarce object must be desired by at least two parties and possessed by one-or-more third parties**.

- Inclusion of the term **“and acceptance of bids”** reflects the need to ensure that an exchange takes place. There is no market in the absence of an exchange.
- An **“object”** can be a good, service, or asset — where the asset can be tangible (eg. cash, contract) or intangible (eg. information, control). The object could also be a ‘prize’ (eg. something that merely by virtue of its attainment is perceived to create value for the acquiring party).
- The object being exchanged must be sufficiently **“scarce”** that the parties have an interest in pursuing an exchange.
- The inclusion of the term **“non-altruistic”** reflects that the exchange cannot be motived by any form of shared interest between any of the parties to the exchange.
- The reference to **“free”** means the exchange must be pursued voluntarily and free of any coercive influence being brought to bear on any of the parties to the exchange.
- In the context of this definition of competition, **“fair”** means objects are offered and exchanged in the way that consumers expect or are led to believe. It also means there are no prior arrangements, agreements or understandings between the parties that have the potential to bias the outcome of an exchange.

The three adjectives included in this definition (non-altruistic, free and fair) are necessary to ensure the competitive discovery process is true and unbiased.

Exchanges that are made with altruistic objectives cannot reveal true preferences over an object because the exchange is motivated by interests that extend beyond the object being exchanged.

Similarly, a decision to exchange that is not made feely will not reflect the true valuation assigned to the object by the party experiencing duress or coercion.
A buyer with a metaphorical gun being held to his head, is likely to pay more for an object that might otherwise be the case; and conversely for a seller.

The term ‘fairness’ is potentially the most open to confusion because it can adopt many different meanings.

The definition assigned above to ‘fairness’ is specifically limited to the nature of the exchange — rather than the outcome *from* the exchange. This specific definition should not be confused with at least two alternative and common uses of the term ‘fairness’ when markets are discussed. First, fairness is often used in the context of a guarantee that vulnerable customers should not be disadvantaged relative to other customers (for example, in terms of access to a service, the quality of service or the price paid). Second, an even broader meaning assigned to ‘fairness’ relates to an equality of outcomes for all; and if not outcomes, then at least opportunities.

These two latter definitions are important within the context of a broader policy debate, but they do not need to be embedded within the definition of competition.

The definition for competition provided above implies ‘competition policy’ can be viewed as the introduction of competition where it was previously non-existent and the removal of as many barriers to competition as possible — thereby allowing the competitive process of discovery to operate with the lowest *acceptable* transaction costs.

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The inclusion of the three adjectives — non-altruistic, free and fair — in the definition of competition, does not appear to be particularly contentious. Indeed, their inclusion seems little more than a statement of the obvious. Their inclusion, however, raises some profound questions about the operation and consequences of competition in certain markets. In turn, this raises questions about the appropriate regulatory response to competition in those markets. These questions are explored throughout the remainder of this paper.

## 4. THE MISSING CHOICE

It is reasonable to assume that altruism has no significant role in determining the nature of an exchange when the provision of a service is undertaken in a commercial environment. That said, some providers may act altruistically as part of their commitment to corporate social responsibility. For the main part, these efforts can be expected to be quarantined to a small proportion of customers, for example, customers in the most vulnerable circumstances. Altruism therefore plays no further part in the following discussion.

The notion of fairness, as defined as defined in section 3, is not unusual. It is well established in consumer law and economics. Notions such as misleading or deceptive conduct, unfair contract terms, false and misleading representations, unconscionable conduct, are all very familiar in the Australian Consumer Law. In economics, these issues are discussed under the guise of a market failure known as 'information asymmetry' whereby the parties to an exchange are in possession of different information, for example, about the quality of the object being exchanged. An example of how these issues are address in the law can be found in section 24 of the Australian Consumer Law (see Box 1).

From whichever direction the notion of fairness of exchange is approached, the consequence of its absence is the same. Competition cannot succeed in fulfilling its purpose of discovery if there is a 'power' imbalance that allows one party to take advantage of another party during an exchange.

The absence of fairness is a very tangible deficiency and, therefore, not surprisingly, it draws the greatest attention from the regulatory community. For example, there is currently a great deal of attention being paid to the need for improved customer information, awareness and engagement in the retail energy market. To this end, various national and state reviews have all made recommendations covering areas such as:

- consumer awareness campaigns including promoting awareness of the government comparator websites
- better product disclosure such as simpler fact sheets and comparison rates
- greater transparency of information provided on bills

- informing customers, particularly those who have not switched to a market offers, of the savings they could make by switching
- informing customers of expiring fixed benefit periods in market offers
- clearer information about customers' energy consumption and how it might be managed
- providing customers (and their agents) with easier access to usage data.

**BOX 1. Australian Consumer Law – Section 24: Meaning of *unfair***

(1) A term of a consumer contract is unfair if:

> (a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
>
> (b) it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
>
> (c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

(2) In determining whether a term of a consumer contract is unfair under subsection (1), a court may take into account such matters as it thinks relevant, but must take into account the following:

> (a) the extent to which the term is transparent;
>
> (b) the contract as a whole.

(3) A term is transparent if the term is:

> (a) expressed in reasonably plain language; and
>
> (b) legible; and
>
> (c) presented clearly; and
>
> (d) readily available to any party affected by the term.

(4) For the purposes of subsection (1)(b), a term of a consumer contract is presumed not to be reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term, unless that party proves otherwise.

Informing these efforts is a newfound interest in the insights afforded by the behavioural economics literature or behavioural insights units that have sprung up. Sometimes known as 'nudge economics', this approach acknowledges the human quality of exchange, particularly as far as consumers are concerned.[12] Unlike the

[12] The term was popularised by Richard H. Thaler and Cass R. Sunstein in their book: *Nudge: Improving Decisions About Health, Wealth and Happiness* (2008)

neoclassical view, where consumers are treated as data-rich and highly effective computational beings, the ‘nudgistas’ view consumers as being prone to innumerable decision-making biases. The neo-classicists view consumers’ failure to self-optimise their interests as the product of imperfect information environments. The nudgistas see the absence of self-serving decisions as the product of heuristics that are misaligned with the decision-making environment in which consumers (or citizens) are operating.

No matter the efforts made by the neo-classicists to provide more beneficial information to consumers, or the efforts made by the nudgistas to goad customers into making ‘better’ decisions, these efforts alone cannot deliver a competitive market outcome. Indeed, in some instances, they will *never* deliver a competitive market outcome — namely, when exchanges are not made freely.

The idea that exchanges must be freely made is hardly contentious. The more challenging question is:  What constitutes the absence of free exchange?

Clearly, deciding on whether to partake in an exchange while having a gun held to one’s head represents a decision made under duress. Fortunately, such decisions are rare.

Economics devotes a great deal of attention to markets in which supply is only available from one supplier. In these monopoly markets, consumers have no option but to purchase the service from the monopolist. This extends significant market power to the supplier which can be exploited to extract rents or supernormal profits at consumers’ expense. Worse still, society is made worse-off because the monopolist will limit production to the level that maximises its profits rather than producing to a level that satisfies society’s needs. Monopoly markets therefore fail the test of efficiency described in section 3.  Economists refer to this lost efficiency as a deadweight loss.

Monopoly markets fail to satisfy the definitions of contestability, competition and efficiency discussed above. It is for this reason a great deal of intellectual effort has been invested over the last century in the appropriate public policy response to monopoly markets. It is these efforts that have led to the creation of state and national regulators to oversee and regulate monopoly or monopoly-like markets.

But even monopoly markets are not completely devoid of choice. Anyone who has studied even the most rudimentary microeconomics will be familiar with the supply and demand diagram for a monopoly market. It always contains a downward sloping demand curve. This is important. It is important because a downward sloping demand curve signifies there are other products (or 'objects') available to consumers that serve as substitutes to the one supplied by the monopolist. Alternatively, it signifies that although the product is desired by consumers, that desire is tempered by the price being charged.

The question of free exchange goes beyond whether the object is supplied by a monopolist or multiple providers. The existence of multiple providers certainly creates the opportunity for customer choice. But even freedom of choice of supplier does not address the issue of whether a customer has a choice over whether to consume a particular service.

The most fundamental choice a customer can make is the choice over whether to consume at all.

It is hard to conceive of too many goods or services for which this fundamental choice does not exist. There are certainly many goods which are very important to our daily lives and we would be very reluctant to surrender our consumption of these goods; but at some point — or at some price — we would ultimately surrender this consumption and redirect our resources elsewhere. That alternative good might be a substitute for the one just surrendered, or it might be a completely unrelated good offering a completely different form of benefit. For example, if wine became too expensive or too difficult to access, a consumer could switch to consuming spirits. Alternatively, they could forgo alcohol entirely and redirect their resources to purchasing more clothes or overseas travel.

However, there are certain goods or services over which no such choice exists. Water has no realistic substitute and the benefit derived from consuming water cannot be substituted by consuming unrelated goods (such as clothes or overseas travel). Moreover, beyond a certain minimum level of consumption, there is no realistic choice about how much water to consume — no matter the price.

In other words, **there is no (or very limited) choice over consumption when that consumption is involuntary and inelastic**. Decisions regarding the consumption of water are not made freely. They *cannot* be made freely. The absence of this freedom is not the result of government policy. And choice of consumption cannot be established by dint of a government policy decision. This outcome is a characteristic of water, not government policy.

It's important to recognise that the absence of choice over water consumption has nothing to do with the 'natural monopoly' characteristics of the water supply system.[13] Although public ownership or regulation of the water industry is typically explained as being necessary because of these natural monopoly characteristics, it could just as readily be explained by the involuntary and inelastic nature of water consumption.

The involuntary and inelastic nature of this 'essential service' explains why communities, and their governments the world over, subject their water suppliers to strict price regulation. This regulation prevents the exploitation of essentiality in the pursuit of commercial objectives.

Water is not alone in being an involuntary and inelastic purchase.

The household consumption of electricity (and to a lesser extent gas) are similarly involuntary and inelastic. Empirical studies have estimated the long run elasticity of electricity demand lies between -0.08 and -0.15. Comparable studies of water demand find household elasticity to lie around -0.05 to -0.1. In other words, even a huge increase in prices will lead to only a very small decrease in consumption. Mere observation confirms this finding. Electricity prices have doubled over the past few years but there has been only the slightest reduction in household consumption.

Like water, consumption of electricity is involuntary and highly inelastic. The purchase of electricity cannot be characterised as a free exchange. It is an essential exchange and it cannot be avoided.

And if that exchange is not free, then the discovery process that defines competition cannot operate properly. In which case, the retail energy market cannot lay claim to be a properly or genuinely competitive market. It's not a properly competitive market because customer purchases are not being entered into freely.

This is unlikely to be a popular conclusion.

[13] The water industry represents a 'natural monopoly' because it would be too costly for a rival supplier to replicate the infrastructure of the incumbent.

Surely, it will be claimed, a market with many retailers actively marketing to attract customers must be competitive. Such a response is the unfortunate consequence of 25 years of market reform based on a word that has no formal definition for policy purposes. In this semantic void, the term 'competition' has come to represent any situation of rivalry. But rivalry is the product of contestability rather than competition.

The definitions provided in section 3 imply that the presence of many retailers, and the low barriers for new retailers to enter the market, only satisfies the definition of contestability — the purpose of which is to enable choice. Choice in its own right is a necessary, but not sufficient, condition for competition. It will only be sufficient if that choice is exercised in a free, fair and non-altruistic exchange. That requirement is violated in the retail energy market. It may also be violated, fully or partially, in various other markets.

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In energy and water markets, choice of consumption is a characteristic of the product rather than government policy. In other markets, government policy may be responsible for removing a choice over consumption. Some examples might include compulsory superannuation or compulsory third-party insurance. In yet other markets, for whatever reason, some or all individuals might act *as though* they have no choice over consumption.

Whatever causes choice over consumption to be absent, the consequences of competition are likely to be similar for participants in these markets.[14]

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[14] The market outcome experienced by consumers will also depend on the regulatory environment in which each of these markets operate.

We have become so accustomed to seeing competition where only contestability exists that suggestions that the retail energy market is not competitive will seem incredulous.  But an uncomfortable conclusion cannot be dismissed simply because it is inconvenient.  And if the retail energy market is not competitive, what conclusions might be drawn about other markets where demand is largely involuntary and inelastic?

The following section explores the significance of markets in which exchanges are not entered freely.

## 5. THE UNINTENDED CONSEQUENCE OF THE MISSING CHOICE

Most consumer markets involve exchanges that are made freely. Those exchanges typically involve a suite of consumption choices. For example, before purchasing a motor vehicle, a prospective consumer must firstly decide:

- whether to purchase a car or whether to use alternative forms of transport

This is followed by decisions about:

- what characteristics and features should the car have
- which model and from which manufacturer
- which dealer(s) to approach, and
- whether to accept or reject the price(s) offered.[15]

The process of engaging with the motor vehicle market (comprising of multiple models, manufacturers and dealers) reveals customers' preferences over all the possible variables; and the customer's willingness to pay a higher or lower amount depending on those variables. This is the process of discovery described by the Austrian school discussed in section 3. It reveals customers' preferences to suppliers and it reveals suppliers' offering to customers. Where suppliers' offerings meet consumers' requirements an exchange takes place. Suppliers use this information to inform their production decisions. That is, contestability of models, manufacturers and dealers leads to a competitive process involving free exchange between suppliers and consumers which, in turn, results in the efficient allocation of society's resources.

This competitive market can be compared to other markets where the discovery process looks very different.

Returning to the example of electricity: Consumers do not choose whether to purchase electricity. Nor do they get the opportunity to consider which 'type' of electricity they will buy or from which 'manufacturer' (as all wholesale electricity is traded through an electricity-only centralised pool). As numerous commentators

[15] Acceptance or rejection of a price may be preceded by some haggling as the prospective customer and dealer seek to identify each other's true valuation of the vehicle.

have noted, electricity is a homogeneous product with little to no scope for innovation.[16] For example:

> *"Gas and electricity are extreme examples of homogenous products in that the energy that customers consume is entirely unaffected by the choice of retailer."*
>
> — Competition Markets Authority (UK)[17]
>
> *"[F]or the majority of customers, retail innovation has not delivered substantial improvements that help them manage their usage or materially improve the way they access energy."*
>
> — Australian Competition and Consumer Commission[18]

Compared to the car market, the only choice available to electricity customers is to select which retailer(s) to approach and whether to accept or reject the price(s) they're offering.

A further and equally important difference between the two markets is the temporal aspect of the exchange. Once payment for the car is handed over, the new owner drives the vehicle away marking the end of the exchange. In contrast, electricity contracts are long-lasting and cover multiple consumption and payment periods. Moreover, the electricity retailer can alter at any time the price the customer pays for their ongoing supply (subject to some notification requirements).

In these circumstances, it is hard to see what the process of competitive discovery is intended to reveal about the exchange. It reveals nothing about whether the consumer wishes to purchase electricity. It reveals nothing about 'type' (or quality) of electricity the consumer values. And it reveals nothing about the trade-offs the customer is willing to make about the quantity of electricity they purchase at different prices because the quantity of electricity consumed is largely fixed and independent of the price offered or charged. Alternatively stated, the **competitive process reveals nothing about customers' willingness to pay in particular markets**.

[16] The opportunity for innovation is revisited in section 8.
[17] Competition Markets Authority (2016) *Energy market investigation. Final report*. p.21
[18] Australian Competition and Consumer Commission (2017) *Retail Electricity Pricing Inquiry: Preliminary Report*. p.101

And if that's the case, then the only matter that remains to be revealed by the competitive process is customers' willingness (or ability) to shop around. Willingness to shop around is the only information the competitive process reveals. That information benefits only one party to the exchange: Retailers.

**By revealing customers' willingness to shop around, competition enables retailers to exercise price differentiation** whereby different customers are charged very different prices for *exactly the same* electricity or gas.

Retailers achieve price differentiation by making multiple offers available at different prices — and to alter the prices paid by existing customers — and observing how customers react to these changing prices. Over time, retailers develop profiles of different customer types according to the likelihood that they will shop around based on the price they're paying and the prices on offer in the market. As these profiles become increasingly sophisticated, retailers are able to widen the dispersion of prices they charge existing customers and the offers they make to potential customers. This is a rational, commercial response by retailers in these market circumstances.

It is certainly true that those customers who are willing to make the necessary effort to shop around can find themselves paying significantly less than other customers for their electricity.

In the state of Victoria, which has Australia's most contestable retail energy market, there are over 20 active retailers with more licence applications on foot. Each retailer has multiple offers available in the market. A typical Victorian household willing to shop around can find itself confronted by dozens of different offers. Prices can vary enormously across these different offers. Indeed, prices can vary almost by a factor of two — yet the electricity delivered is exactly the same.[19]

It is hard to imagine two car dealers operating in the same local market selling exactly the same model vehicle where prices vary over such a large range.

It is through their willingness (or ability) to wade through this plethora of offers that customers reveal to energy retailers their willingness to shop around.  This willingness to shop around is revealed when a customer's contract is coming to an

[19] Contracts can vary in their terms and conditions, but the electricity delivered is not different as a result of these varying terms and conditions.

end. It is similarly revealed by how a customer responds when their retailer increases the prices they are paying during the term of their contract (which is allowed under the energy rules). Likewise, it is revealed by how customers respond when other retailers offer better prices than their own retailer.[20]

Once in possession of this information, retailers can increase the prices they charge different customers based on their willingness to shop around. The most 'sticky' customers — those who are least able or willing to shop around — will find themselves paying the highest prices. Customers who have been revealed to only shop around occasionally are likely to find their retailer gradually ratcheting up the price they are pay. Retailers are less likely to ratchet up the price faced by the most 'footloose' customers (that is, customers) who are known or assumed to shop around most willingly.

If all service providers are profiling customers (or even if just the big players in each nonsumer market are doing so and smaller providers are free-riding), then not only will price differentiation widen, but the weighted average price will also increase.[21]

*

It has been argued that the dispersion of prices observed in the retail energy market is explained by the well-established theory of price discrimination.[22] These theories of price discrimination rely on retailers distinguishing classes of customers according to their *willingness to pay* for particular goods or services. Customers whose demand is more inelastic pay more than customers whose consumption is more sensitive to the price being charged. In this way the overall benefit derived from the market is increased with more people are able to consume more services. The most commonly cited examples include movie and airline tickets. Cinemas sell more tickets by charging juniors, students and seniors a lower price because these customers are more price sensitive. Airlines sell more tickets by lowering prices for passengers who are willing to book far in advance or wait till the very last moment.

[20] Note, there are very low exit fees for customers who break their contract to switch to another retailer.
[21] Ben-David, Ron (2018) *The unfortunate paradox of retail energy prices.* Australian Energy Week (11 May)
[22] Simshauser, Paul and Whish-Wilson, Patrick (2017) *Price discrimination in Australia's retail energy markets: An analysis of Victoria and South East Queensland.* Energy Economics 62 (2017) 92-103

But these economic theories and commercial pricing practices do not explain the different prices paid by electricity customers because electricity consumption is not sensitive to price. As already noted, household energy consumption is largely fixed. In which case, energy retailers cannot discriminate customers according to their willingness to pay (i.e. their elasticity of demand). Instead, retailers are price differentiating between customers based on some other characteristic — namely, their willingness to shop around. Willingness to shop around is not the same as willingness to pay. Therefore, the price differentiation observed in the retail energy market is not the same as the price discrimination presented in economic textbooks. **Unlike price discrimination, price differentiation does not lead to more customers benefiting from more consumption. It produces no social or societal benefit**.

Box 2 illustrates the difference between price discrimination in markets with free exchange and price differentiation in markets without free exchange.[23]

It has recently been suggested that as competition deepens in the retail energy market (where exchanges are not free), the dispersion of differentiated prices increases. This analysis also suggests that as competition intensifies the costs associated with competition increase. Because customers are unable to exit the market, these costs are passed through to customers. In other words, not only does competition in this market result in price differentiation based on willingness to shop around, it also sees the weighted average price increasing over time.[24]

Interestingly, the same analysis suggests that energy retailers' opportunities to pursue strategies of price differentiation may be reaching their limit.[25] This suggests that retailers will increasingly become dependent on strategies to attract customers with low prices, but then gradually increase those prices once the customers has become accustomed to their new retailer. Prices will increase at a rate that depends on the expected or known willingness of each customer to shop around.[26]

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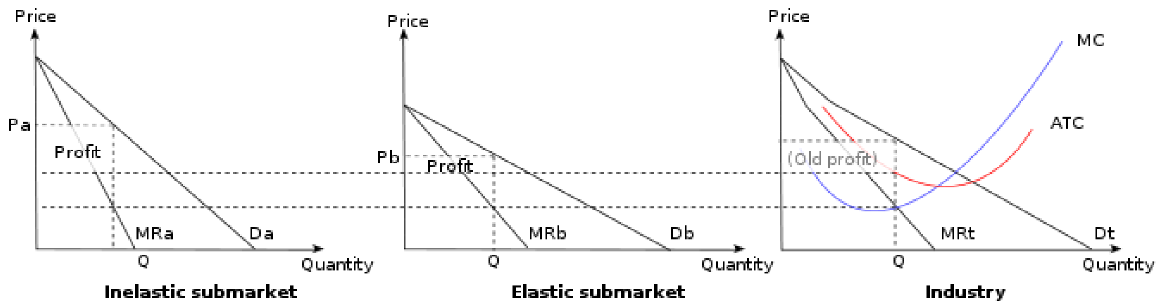
[23] The author continues to work on graphic models of price differentiation.
[24] Ben-David, Ron (2018) *The unfortunate paradox of retail energy prices.* Australian Energy Week (11 May)
[25] Ben-David (2018) *ibid*
[26] Ben-David, Ron (2017) *Do discount wars benefit retail energy customers? Don't bet on it* (28 February)

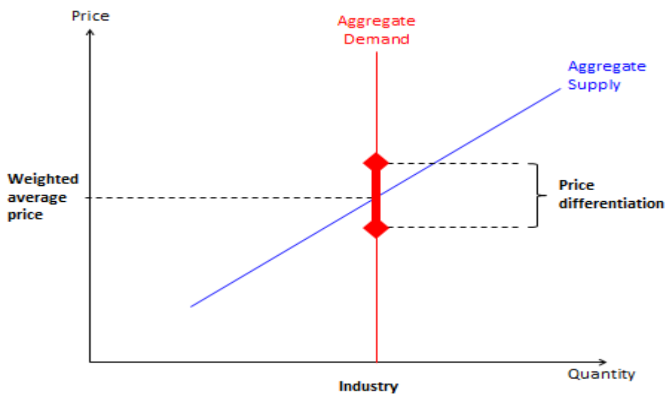
**Box 2. Price discrimination versus Price differentiation**

Price discrimination is usually illustrated by the following diagram. It shows firms charging different prices to different groups of customers based on their different elasticities of demand. Customers who are less price sensitive pay higher prices than customers whose demand is more price elastic. The supplier discriminates based on customers' differing willingness to pay. This maximises firms' profits and it sees higher sales — providing more customers with the benefit of consumption.




Price discrimination is no possible in markets where consumption is involuntary and largely inelastic because firms cannot be distinguished customers according to their differing elasticities of demand. While customers will vary in their willingness to shop around, this does not affect their consumption requirements.

If firms can differentiation between customers based on their willingness to shop around, then they will charge higher prices to customers who are less willing to shop around. The higher prices paid by these customers will be used by the firm to 'cross subsidise' lower prices offered to customers who are more inclined to shop around. The weighted average of prices paid across all customers will equal the market clearing price.




The author is doing further work on diagrammatic representations of willingness to shop around and how it supports price differentiation by firms supplying in markets where consumption is involuntary and largely inelastic.

Of course, the retail energy market is not the only market in which purchases are not freely made.

It is possible to construct any number of scenarios in which a purchase might be made under some form of duress. Examples might include: purchasing food when the local supermarket is closed or hailing a taxi late at night. Other examples might include purchases that take place within a supply chain, for example, car manufacturers who must buy steel or rubber to make cars.

Would these examples suggest that the duress experienced by the hungry customer, the stranded passenger or the car manufacturer, negate the existence of competition in the markets occupied by convenience stores, taxis or steel makers?

In the case of the first two examples, it is worth noting the difference between a single purchase that might be made under duress and an entire market where *every* purchase is subject to duress. While the hungry customer may not have much choice over where they purchase food in a particular instance, ultimately, they retain the option of shopping when the supermarket is open or to travel to the next suburb to make their purchases. In other words, non-duress based options exist. The same may not be true for the stranded passenger which is why taxi fares are generally remain subject to regulation.[27] In the latter example, although the car manufacturer has no option about whether to purchase steel, the capital invested in the car manufacturer remains invested in that firm by choice. Looking through the firm to its beneficial owners makes clear that the ongoing purchase of steel is a voluntary decision. Unlike owners of capital, customers in markets like the retail energy market cannot 'walk away' if the market price increases.[28]

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[27] It's worth noting that while booked taxi fares will be fully deregulated in Victoria from 1 July 2018, unbooked fares will continue to be regulated.
[28] This is not intended to suggest that capital is not at risk despite being free to exist. It has recently been suggested that competition law can be seen as the response to these risks. See Biggar, Darryl and Heimler, Alberto (2017) *The economic fundamentals of competition law*.

In the typology presented in section 3, choice is described as the product of market contestability. Competition is intended to take that choice and use it to identify the most favourable outcome possible for consumers (and producers) in the achievement of an efficient outcome.  When the ultimate choice is not available to consumers — namely, the choice not to consume (or even to consume less) — the choice provided by contestability greatly limits the opportunities for discovery afforded by competition. Indeed, competition in the retail energy market may reveal nothing more than customers' willingness to shop around. The value of this information is highly asymmetric and it unequivocally falls in retailers' favour.

This is not the outcome intended by the market reformers of the 1980s and 1990s. Competition has not produced the free-flowing markets they anticipated. The absence of free exchange has stymied the development of those markets.

The absence of free exchange means customers have no consumption choice to make. And if there is no consumption choice to make, then is there even a consumer?  Could these be markets without consumers?

Enter the *nonsumer*.

## 6. THE RISE AND RISE OF NONSUMERS

When purchases are not the product of free exchange, then there is no consumption decision to be made by the purchaser. If there is no consumption decision being made, then purchasers are not truly “consumers”.

Rather, the purchasers of these services may view themselves as “nonsumers”.

Nonsumers are involuntary market participants. Nonsumers do not make consumption choice. They have choice of supplier only. Whether nonsumers choose to shop around or not, does not alter their status as nonsumers.

Nonsumers and consumers are not ‘the same but different’.

By definition, consumers have an interest in making purchases because the exchange is entered freely. They enter markets voluntarily in pursuit of satisfying those interests. These interests are finite. Finite interests can be discovered and measured through a competitive process which reveals consumers’ willingness to pay.

In contrast, nonsumers’ interests are infinite insofar as their demand is inelastic. In this sense, their interests in making a purchase are unmeasurable and therefore undiscoverable through a competitive process. In nonsumers markets, the competitive process decays to a lesser process which only reveals nonsumers’ willingness to shop around. Or, as discussed in section 5, the only consequence of competitive reforms for nonsumers is that it *forces* them to reveal their willingness to shop around. Alternatively stated: **Competition forces nonsumers to reveal their tolerance of price exploitation.**

*

Nonsumers have existed in certain markets since the introduction of the competition and deregulatory reforms of the 1990s. Initially, their presence went largely unnoticed because little or nothing was known about them. With the passage of time, suppliers have gradually discovered the varying levels of willingness to shop around among nonsumers. As noted in the previous section, this has led suppliers to price differentiate between different types of customers according their tolerance to exploitation.

Given the likely disutility from constantly guarding against price differentiation (see next section), nonsumers can be expected to fall into three broad categories. The first group consists of nonsumers for whom the disutility from shopping around is so great they never do so. These nonsumers will be paying the highest prices in the market.  The second group consists of nonsumers for whom the disutility from shopping around is significant but not prohibitive. These nonsumers will tend to find their prices increasing between their efforts to shop around. The third group of nonsumers shop around routinely to avoid being subjected to price creep (whereby their prices are gradually increased).

As suppliers' capacity to differentiate between (and within) these different categories of nonsumers improves, the range of prices paid by nonsumers will grow. No individual supplier can resist this trend for fear of losing nonsumers from the second category to its rivals.[29]  As a result, the differential pricing of nonsumers becomes self-perpetuating.

As that differential pricing process deepens, the consequences of the competitive reforms become more evident to more nonsumers who, as discussed in section 7, express their dissatisfaction increasingly vocally through the political process.

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A quarter of a century after the competitive reforms of the Hilmer Review helped propel the Australian economy to new heights of prosperity, community dissatisfaction with some of those reforms is becoming louder. Some view this dissatisfaction as a vote of ingratitude borne of a complacent community that has forgotten about the gross inefficiencies (and inequities) of the past.

Maybe so.

[29] Ben-David, Ron (2017)  *Do discount wars benefit retail energy customers? Don't bet on it*  (28 February)

However, this view overlooks (or dismisses) **the frustration of nonsumers who find themselves working harder than ever before in order to avoid greater levels of exploitation than ever before**.

But no amount of shopping around can alter the reality that some exchanges are not entered into freely.

Merely telling nonsumers to shop around for 'savings' is unlikely to assuage their growing sense of injustice.  It is a sense of injustice driven by having to shop around even though the purchase is involuntary. It is a sense of injustice borne from having to shop around ever more assiduously just to avoid being exploited.

It is this growing sense of injustice that is seeing nonsumers increasingly demanding answers. And as recent history shows, when nonsumers find their voice, the polity listens.

As the old adage might suggest, **"The nonsumer is always right."**

## 7. NEO-PATERNALISM AND THE ENDOGENEITY OF REGULATION

Economists might wish to believe that competition policy is values free, but nonsumers are challenging that assertion ever more loudly. Persisting with enforced choice in an environment where the competitive discovery process is limited to imposing a need to shop around merely to avoid exploitation, challenges the boundary between economics and morality — and therefore, it challenges the politics of *nonsumption*.

*

Professor Cass Sunstein from Yale University (and also of 'nudge' fame[30]) has noted that there are multiple reasons why people might decline to make a choice when presented with the option to do so.[31] Customers might aver from choice because they:

- believe they lack information or expertise
- fear they'll make a mistake
- not enjoy the act of choosing
- prefer someone else decided for them
- not want to take responsibility, or
- be too busy.[32]

In these situations, Sunstein concludes,

> *"Active choosing saddles the chooser with responsibility for choice, and reduces the chooser's welfare for that reason."*

[30] Thaler, Richard H. and Sunstein, Cass R. (20o8): *Nudge: Improving Decisions About Health, Wealth and Happiness* (2008)

[31] Cass R. Sunstein (2017) *Requiring choice is a form of paternalism*. Journal of Behavioural Economics for Policy, Vol. 1, No. 1, 11-14.

[32] In nonsumer markets, where the transactional relationship between supplier and customer is often ongoing rather than one-off, an additional cause for aversion is a mistrust that an initial customer decision will result in ongoing benefits. For example, survey data from retail energy customers highlights they often don't expect a good deal to last (i.e. they expect the retailer will eventually increase their prices).

Sunstein's consideration of these aversions is not directed specifically at market-based decisions. For example, he refers to choices such as organ donation or end of life care. Of course, they might also apply to choices that need to be made in consumer markets. When such choices are exercised in consumer markets the reduced welfare (or disutility) from having to make a choice is offset by the utility gained from the consumption gained by virtue of that choice. This calculus in shown in table 1.

A consumer will continue to purchase a particular good or service as long as the positive benefits they derive from doing so outweighs the disutility they experience from making that purchase. When this calculus tips into the negative for too many customers, they cease to make that purchase and the market for that good or service ceases to exist.

**Table 1 Weighing up the merits of making a purchase**

| Positive benefit from exercising choice | Negative effects of exercising choice |
|---|---|
| Utility gained from consuming the chosen good or service | |
| Utility gained from searching for the chosen good or service<br>*i.e. "I shop to relax"*<br>*"I love the thrill of the hunt"*<br>Avoided disutility from foregone consumption<br>*i.e. "I hate being ripped-off"* | Disutility from search and transaction effort<br>*i.e. "I hate going shopping"*<br>Disutility arising from having to exercise choice<br>*i.e. "I hate choosing" — see list by Sunstein* |

It is worth contrasting this calculus with the one that operates in markets where contestability provides consumers with a choice over supplier, but circumstances deny them a choice over whether they consume or not. That is, it is worth considering how this calculus applies to nonsumers when they make involuntary purchases.

If a nonsumer has no choice over whether to consume a service — say, water or electricity — the utility they derive from that 'nonsumption' must be very large. Indeed, it can be said to be undefinable or infinite.

An infinite level of utility has some odd implications. First, it appears to imply that nonsumers of, say, electricity, would not need to consume any other goods or services because they would be fully satiated just from their consumption of electricity.  Second, it suggests that no matter the magnitude of the disutilities listed in Table 1, consumers would still feel satisfied merely from the nonsumption of electricity. In turn, this would imply suppliers could provide increasingly poor quality service and customers would remain completely indifferent. Clearly, neither of these implications are realistic.

It therefore seems likely that, when assessing the value of the utility derived from services over which they have no choice, nonsumers assign zero weighting in their welfare functions to the utility drawn from those purchases. When nonsumers have no choice over whether or not to purchase a particular service, they don't take into account the benefit they derive from that service because they're not making any active decisions in regard to that purchase.[33]

Nonsumption and consumption differ in other ways.

Customers are likely to experience an unpleasant interaction in a nonsumer market more acutely than an equally unpleasant interaction in a normal consumer market. This is because consumers will offset this unpleasant experience with the utility they ultimately obtain from consuming the service. In contrast, nonsumers attach zero weight to their nonsumption of these services leaving them only to experience the disutility with no offsetting benefit.

The stronger the aversions listed by Sunstein, the greater will be the disutility nonsumers experience. Moreover, it is likely that any such disutility will be amplified further by the customer's inability to walk away from the market — that is, decision-making under duress can be expected to amplify disutility compared to decision making in other markets.

[33] This is also likely to imply that customers deduct the expected expenditure on these services from their budget constraints. If this were not true, they would systematically over-consume other goods and services (that is, they would consume those goods and services beyond their budget capacity).

This explains why certain industries are more often in the political eye than others — for example: energy, banking, superannuation, insurance and fuel. The disproportionate attention given to these nonsumer markets has two potential explanations.

First, dissatisfied customers will always vent their frustration if they have an unpleasant experience but ultimately, as consumers, they can vent that frustration by walking away from the market. Unhappy consumers always retain the option not to make a purchase — now or ever. Nonsumers are denied the opportunity of walking away from the market. No matter the extent of the disutility they experience, they must still make a purchase. Nonsumers' only option is to vent their dissatisfaction to anyone who will listen. This might include friends, neighbours, radio comperes or their political representatives. Only the latter have an obligation to listen.

Second, the involuntary nature of nonsumption creates a sense of entitlement to nonsumer services. Sometimes, this sense of entitlement is described in terms of a "social licence" that is awarded to service providers. Because of the involuntary nature of nonsumption, the social licence places expectations on the suppliers of these services that exceed those that are placed on suppliers in normal consumer markets. When that social licence is perceived to have been breached, it leads to feelings of injustice. Justice and the restoration of justice are typically viewed as political responsibilities.

*

Typically, the economic response to political and regulatory interest in markets is to see such interests as an impediment to competition and efficiency. The claim of "bad politics getting in the way of good economics" is a familiar one.

The luminaries of the microeconomic revolution of the 1990s were schooled in the preceding decades when the neo-classical model was in its ascendance. In that model, the role of government was limited to addressing market failure; and once any specific failures had been addressed, government had no further role to play.

Any further actions taken by government or pursued by well-intended policy advocates were dismissed as paternalism.[34]

According to the definition of competition provided in section 3, paternalism is likely to interfere with consumers' preference-revealing consumption decisions — thereby eroding the competitive process and the possibility of an efficient market outcome. In this sense, paternalism is the antithesis of a competition-focused reform agenda which centred on providing customers with choice. The exercise of that choice would drive the competitive process; and the competitive process would deliver an efficient outcome envisaged in section 3.

The more recent approach of behavioural ('nudge') economics is not overly different. It merely views the exercise of choice through a different set of lenses. Whereas the neo-classical economists see choice as a rational calculation informed by the required data set, the nudgistas see choice as a very human decision influenced by a multitude of human biases. The neo-classicists focus on helping customers overcome limitations in their data sets while the nudgistas focus on compensating for biases in consumer decision-making process.

Both schools uphold the same belief, namely, the primacy of individual choice and its pre-eminence in delivering an optimal outcome for individuals and for society as a whole.

However, neither approach offers a solution to the competitive conundrum when choice over consumption is absent. The absence of free exchange cannot be corrected through improved data sets, nor can it be corrected through compensating for human biases. Despite these limitations, adherents and acolytes of both schools continue to throw themselves with unerring gusto at the 'problems' encountered in numerous markets where free exchange is limited. Both continue to see more choice and improved decision-making as the solution. In other words, expecting and even demanding nonsumers exercise (better) choice is still the dominant philosophy for addressing observed shortcomings in these markets.

[34] 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'.

Both schools place the onus on customers. Competition means customers must shop around. Customers must shop around to avoid paying higher prices. Customers must shop around to avoid suppliers charging them higher prices. Customers must shop around if they wish to avoid price exploitation by suppliers.

The obvious corollary is that unless customers shop around, suppliers are entitled to charge as much as they can for their services.

Free exchange is the safeguard against exploitation available to customers in competitive *consumer* markets. The opportunity to 'walk away' from the market is the most powerful consumer right that countervails against the power of suppliers.

At the same time, competition imposes responsibilities on customers to protect themselves from exploitation. *Caveat emptor*. Competition policy is not seen as paternalistic because it provides customers with the freedom and rights to choose — the freedom to shop around and the right to walk away from the market.

In markets where free exchange is not possible, this latter right is non-existent.

Based on the belief that the competitive process is always welfare enhancing, the reformers have denied nonsumers the right *not* to participate in a competitive process. Nonsumers cannot walk away. They have been denied the right <u>not</u> to reveal their willingness to shop around. **Nonsumers have been denied the right not to expose themselves to exploitation.**

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If paternalism denies people the right to choose, then neo-paternalism denies them the right *not* to choose. By introducing competition into markets where customers cannot freely enter an exchange, the market reformers have acted with neo-paternalistic consequences. In doing so, they have exposed nonsumers who fail to shop around tirelessly to potential exploitation.

**This is not a values-free outcome as economists tend to argue. It is a profoundly moral assertion.** It implies that nonsumers who do not shop around are responsible for the outcomes that befall them in these markets. Nonsumers are responsible; not suppliers, not regulators and not the reformers. Just nonsumers.

Nonsumers are increasingly expressing their resentment at this moral imposition. They are demanding others be held to account for the risks that are being imposed on them — the risk (and reality) of exploitation. This explains the recent multitude of inquiries (including a royal commission) and government interventions in retail energy markets, fuel pricing, banking and other financial services.

From a neo-classical perspective, many of these political and regulatory interventions are seen as exogenous and paternalistic impositions on the market because they are not correcting recognised market failures. That line of thinking may have merit in many markets but it is a flawed conclusion in markets where customers do not enter exchanges freely. In nonsumer markets, political and regulatory intervention is *endogenous* to the market structure. It is the natural consequence of allowing competitive processes to operate in the absence of free exchange.

As noted above, nonsumers cannot express their dissatisfaction by withdrawing from the market. They can only express their dissatisfaction and make demands for redress by exerting themselves politically.

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Nonsumer markets do not fit within existing constructs of how competitive markets should operate. Because the utility gained from the service is the same no matter the effort to shop around, it is excluded from the calculation of whether to shop around. The effort to shop around is motivated only by the desire to avoid exploitation. The avoidance of exploitation is not equivalent to the pursuit of a benefit. Avoiding exploitation does not produce a benefit. **Avoiding exploitation does not represent a "saving". In this case, two negatives do not make a positive.**[35]

[35] Avoiding (negative) exploitation (negatives) does not produce a saving (positive).

Simply attempting to make these markets more ‘competitive’ through the normal policy prescriptions — of more suppliers, better information and greater consumer engagement — is unlikely to ever be a sufficient response. When customers have no other choice but to shop around, simply exhorting them to shop around even more is unlikely to allay their concerns (at least not for long). Indeed, it is likely to sound like neo-paternalistic moralising from on high.

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Neo-paternalism has other consequences in the markets in which customers do not enter exchanges freely. These are consequences that were surely never anticipated at the time competition was introduced into these markets. Yet they exist and they have implications that reach far beyond mere economics. Competition in nonsumer markets induces a tax and transfer system operated by, and for the benefit of, vested interests.

## 8. A COMPETITION INDUCED SYSTEM OF TRANSFERS

Unlike price discrimination in other markets, price differentiation in markets that lack free exchange leads to no shift or increase in consumption and therefore no enhancement of overall welfare. Likewise, it results in no better deployment of society's resources and therefore no improvement in allocative efficiency.

Price differentiation is the product of competition in nonsumer markets. The pressure for price differentiating strategies is amplified further where the product is highly homogeneous and there is little opportunity for service providers to develop enhanced service offerings. In such markets, price differentiating strategies compel suppliers to offer bigger headline inducements in their efforts to attract and retain customers who are willing and able to shop around. The inducements are funded through the higher prices paid by customers who are less (or not) willing to shop around.

It was the CEO of a very large retail energy company[36] who referred to the impost on customers who do not shop around as a 'loyalty tax'. He suggested that in return for their fidelity, these customers pay a 'tax' on their purchases. But this is no normal tax. It is a private tax levied by service providers to fund the inducements offered as part of their price differentiating strategies. Rather than shareholders foregoing earnings to attract customers, service providers in nonsumer markets levy a tax on customers who don't shop around. Unlike in properly competitive markets, nonsumers who are unwilling to shop around cannot avoid these taxes by choosing not to make a purchase. There is no fee exchange in nonsumer markets.

As a result, the tax is passed through in full as a higher price for one set of customers (customers who do not shop around) and the proceeds are used to fund lower prices for another group of customers (those who do shop around). In other words, **competition in nonsumer markets results in service providers running a privately operated tax and transfer system.** In this tax and transfer system, service providers shift funds between customers in their pursuit of market share.[37]

[36] http://www.afr.com/news/big-power-neglects-best-customers-agl-boss-says-20160823-gqzbgu
[37] This tax on customers who are less willing to shop may also fund supernormal returns (or shareholder rents).

In the Victorian energy sector, for example, price differentiation sees hundreds of millions of dollars being transferred around the economy by private interests. Taking into account transfers in other states and other nonsumer sectors suggests that the sums being redistributed under these privately operated transfer systems could reach into the billions of dollars.

Surely this could not have been the market reformers' objectives when introducing competition to these markets. The provenance of tax and transfer systems lies with governments, not service providers. Outsourcing a taxation power to an unaccountable party has no basis in economics or morality.

Transfers require value judgements about who requires assistance, how much they need and who must pay to fund that assistance. These are difficult and value-laden decisions. That's why they are entrusted to representative governments rather than vested interests to decide.

Transfers to support the impaired, the unwell, the abused and the unemployed are established priorities in this country and many others. These and other causes are noble and enduring policy priorities. But has there ever been so trivial a cause for operating a transfer system as funnelling billions of dollars to those who are willing to shop around?

There is no *a priori* reason to believe willingness to shop around is correlated with any of the remediative policy priorities listed above. There is no *a priori* reason to believe that customers who are most likely to shop around (and shop around continuously) will be those who are most in need of financial assistance. **Willingness to shop around is not equivalent to willingness to pay; and it is certainly not equivalent to capacity to pay.**

Transfers that pursue customer based on their willingness to shop around would seem to be an artefact of a competitive process that cannot operate properly when exchanges are not entered freely. In nonsumer markets, discounts are not borne of efficiencies. They are merely transfers and they are made for no apparent social benefit. **It is far from obvious how society is enriched by a tax and transfer system operated by vested interests solely for their own pursuit of customers who are willing to shop around**.

What is the moral basis for handing a taxation power to vested interests in return for this private outcome? What is the moral basis of handing over this taxation power without any accountability for how it is used?

Two hundred and fifty years ago, "No taxation without representation" was the rallying call for a great revolution. Perhaps echoes of that battle cry are now being heard in nonsumer markets halfway around the world. As discussed in section 7, nonsumers are making their dissatisfaction heard ever more loudly. It is a dissatisfaction borne by their having to work ever harder just to avoid a private taxation levied on their essential purchases.

*

The instinctive response to these concerns will be to conclude that customers can avoid the tax by simply shopping around. But that is a false conclusion. It is a false conclusion because it defines the problem in a way that predetermines the answer. That is, it defines the problem as: Why should customers pay a loyalty tax? It makes customers the subject of the problem and therefore it implies they are also the subject of the answer — namely, customers should shop around if they want to avoid paying a 'loyalty tax'.

This is a logical fallacy. It is equivalent to arguing that customers should shop around if they want lower prices because if they don't shop around they'll pay higher prices. This flawed line of argument is known as *petitio principii* (or 'begging the question'). More formally, it is a flawed argument because assuming the initial premise to be correct also means assuming the conclusion is correct.

This flawed argument has sat in the regulatory blind spot described at the end of section 2 — unseen against the dominating narrative of competition policy. Industry and regulators in nonsumer markets have been united for years in their advice to customers: Shop around to save money.

To be clear, customers also need to shop around in regular consumer markets if they want to avoid paying higher prices. But there's a very big difference between those consumer markets and the nonsumer markets discussed in this paper. In regular consumer markets, customers shop around (or not) in order to proceed with a purchase. There is a causal relationship between the decision to shop around (or not) and the decision to make a purchase.

That is not the case in nonsumer markets. There is no causal relationship between shopping around and making a purchase in a nonsumer market. The purchase decision is independent of the decision to shop around. The purpose of shopping around is completely self-referential. As already noted, its logic relies on the flawed argument that customers should shop around if they want lower price because if they don't shop around they'll pay higher prices.

The real question to be answered, therefore, is not whether consumers *can* shop around to save money. The real question is *why should* customers in nonsumer markets shop around to save money? Why must nonsumers shop around to avoid paying a 'loyalty tax' when the only benefit of doing so is avoidance of the tax they'd pay if they didn't shop around?

Or, posing this question in the terms outlined in this section: Why should vested interests be granted the power to tax customers in order to support a system of transfers that has nothing to do with either efficiency or equity?

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This is a particularly confronting dilemma for the regulatory community entrusted to oversee nonsumer markets.

The regulatory response to the nonsumer dilemma is not to simply advise customers to shop around more. And unfortunately, the regulatory response cannot be shoehorned into the playbooks of neo-classical market economics (of more information, more deals and more suppliers) or the "libertarian paternalism" of nudge economics (reframing the decision in favour of a socially beneficial outcome).

A different, smarter and more imaginative suite of responses is required.

## 9. NEXT STEPS FOR REGULATORS AND INNOVATORS

Regulatory prescriptions that are limited to focussing on "making it easier for customers to shop around" are clearly rational in the context of a 'normal' market in which exchanges are free. So rational are such measures in these markets that they rarely require public discussion or attention. Likewise, there are rarely calls for regulatory intervention. There is little need for public exhortation for customers to shop around for carpets or movie tickets. Consumers readily accept that they pay what they pay in return for consuming what they wish to consume. And if they don't which to pay, then they can merely decline to consume. That is their inalienable right as a consumer.

Nonsumers do not have the same options available to them. Even so, they are constantly being exhorted to shop around. Indeed, governments and regulators are increasingly looking for ways to make it easier for nonsumers to shop around. Reports continue to be produced highlighting the need for:

- consumer awareness campaigns including promoting awareness of the government comparator websites
- better product disclosure such as simpler fact sheets and comparison rates
- greater transparency of information provided on bills
- informing customers, particularly those who have not switched to a market offers, of the savings they could make by switching
- clearer information about customers' consumption and how it might be managed, and
- providing customers (and their agents) with easier access to usage data.

These are clearly worthwhile endeavours. As far as the competitive process is concerned, these actions all have the potential to enhance the fairness of market exchanges (see section 3) and therefore improve market outcomes. They may also increase customers' willingness to shop around (at least in the short term). It remains to be seen whether customers' long-term willingness to shop around can be permanently increased.

These actions have little, if any, bearing on whether an exchange occurs freely.  Or in the language of the preceding discussion, it does not appear that these actions can turn a nonsumer into a consumer — no matter how much the regulatory community may will that to be the case.

Arguably, the distinction between nonsumers and consumers has been recognised for some time.

Basic loans are an established product available from the banking sector and the provision of standing offers (or standard retail contracts) is a long-standing regulatory obligation for energy retailers.  In effect, these loans and offers are intended provide customers a 'refuge' from the competitive market. They are intended to provide nonsumers with the opportunity to receive services on fair and reasonable terms without the need to shop around continuously to avoid paying extractive prices.

At least, that's the intention.

The ACCC recently reported that bank customers on basic loans are likely to be paying more than borrowers on standard loans once all discounts on standard loans are taken into account.[38]  Borrowers with basic loans appear to be paying around 25 basis points (or 6 per cent) more for their loans. In Victoria, the Essential Services Commission has found that a typical electricity customer will pay over $400 (or 32 per cent) more per year on a standing offer than on a discounted market offer.[39] The equivalent figure for gas contracts is around $250 (or 18 per cent).

After the fact, it is perfectly obviously that this would be the outcome of allowing service providers to set their own 'refuge' prices. By definition, nonsumers with the greatest reluctance to shop around will remain on refuge contracts. By doing so, they reveal their reluctance to shop around. In the absence of price regulation, it makes perfect commercial sense for service providers to gradually increase the price these customers pay — and use these funds to support discounts for customers who are more willing to shop around.

[38] Australian Competition and Consumer Commission (2018)  *Residential mortgage price inquiry. Interim Report* (March)
[39] Essential Services Commission 2018, *Victorian energy market update: July to December 2017* (29 March)

The very high prices paid by customers with a low willingness to shop around explain why an independent review into the retail energy markets in Victoria proposed the introduction of a regulated, 'no frills' Basic Service Offer (BSO). The review proposed the price of the BSO should be regulated but that, "Retailers would be free to provide other offers to consumers with lower or higher prices, to give consumers the choice to pay for any additional value retailers may offer."[40] At the time of writing this paper, the Victorian government was yet to respond to the independent review's BSO proposal.

In the meantime, and as is already happening, the regulatory community must explore other options that go beyond merely exhorting customers to shop around more; that go beyond merely giving customers more choice; that go beyond merely giving customers more information.

After 25 years of competition policy, **it is time for the regulatory community to exercise the necessary imagination in how it regulates *nonsumer* markets.**[41]

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Of course, innovators have a way of disrupting markets in ways regulators, customers and incumbents cannot foresee.

A thought experiment about the retail energy market may prove instructive. In this thought experiment, a benevolent innovator develops a program that reduces to zero the effort required by customers to shop around. The program takes live feeds of a customer's energy usage and identifies the best offer available in the market for that customer. The program then automatically and costlessly switches the customer to that deal. All this occurs in real time. Customers don't even know, or need to know, this is happening. As far as retailers are concerned, this imaginary program makes the nonsumer appear to be infinitely willing to shop around.

In doing so, the program overcomes the problem of competition in markets where exchange is not entered freely. In these nonsumer markets, competition only reveals

[40] Thwaites, J., Mulder T. and Faulkner, P. (2017) *Independent review of the electricity and gas retail markets in Victoria* (August) p.54
[41] Themes of regulatory imagination and measured risk-taking are discussed further in Ben-David (2018a) *ibid*.

customers' willingness to shop around. However, by making customers infinitely willing to shop around, the program leaves nothing for retailers to discover. And therefore, it leaves them no opportunity for price differentiation. All customers end up paying only the efficient cost associated with retailers procuring, delivering and selling energy to them.

In normal consumer markets, competition serves to ensure contestability delivers an efficient outcome (as described in section 3). In nonsumer markets, competition doesn't work this way. The imaginary program offers an alternative pathway from contestability to efficient outcomes. In effect, it bypasses completely the competitive process of discovery described in section 3.

While such a program may be imaginary for now, that may not be the case for too much longer. In Great Britain, Voltz and Flipper have emerged to facilitate customers switching to lower priced contracts.[42] In Australia, Transformer, has just been launched by the consumer advocacy group CHOICE.[43] The extent to which these programs can match the efficient outcome of their imaginary counterpart will be limited only by their ability to overcome transaction costs and other frictions.

It is also possible to view a recent announcement by the Victorian government in this context. On 22 April 2018, the government announced a Power Saving Bonus that will see Victorian customers paid $50 to visit the government's energy price comparator website.[44] Customers are under no obligation to switch energy deals or supplier. They only need to visit the site. This lifts the profile of the website and if it leads to the website becoming the authoritative source of pricing information for consumers, it will also go some way toward the outcome envisaged by the benevolent innovator's imaginary program.

In the meantime, production and transaction technologies are changing the way customers engage with the retail energy market (along with many other markets). While it is beyond the scope of this paper to discuss how these technologies might interact with the operation of the competitive process of discovery, some of the relevant considerations in the retail energy market will include:

[42] http://www.bbc.com/news/business-36683543

[43] Using customer consumption data and powered by MI Retail Energy software, Transformer will identify the best deals for its customers and it will initiate a transfer of a customer's account to the cheapest retailer.

[44] https://www.premier.vic.gov.au/helping-victorians-bust-their-energy-bills/

- whether these technologies will enable customers to alter their use of energy quickly and at low cost in response to changes in price
- who owns and controls the source of energy production that is powering all or some of customers' needs, and
- whether these new technologies will enable customers to alter (or mix) their sources of energy supply quickly and at low cost.

Of course, there are many other relevant factors; and other nonsumer markets will have their own factors to consider.

But overall, the measure of success for these innovations will be the same in all nonsumer markets. Will innovation liberate nonsumers from the limitations of competition they experience today? Will these new technologies provide customers with freedom of exchange where such freedoms do not exist today? Will these innovations allow the competitive processes to operate as intended rather than as they operate today? Will innovation make consumers out of today's nonsumers?

And if none of that is possible, then the relevant question becomes:

Does the innovative technology, product or service model eliminate or lessen the economic advantage competition hands to suppliers in nonsumer markets?

## 10. CONCLUSION

Competition policy has been one of the most significant economic policy agenda in decades. It introduced flexibility into an ossified economy and paved the road to national prosperity. But not all markets have evolved as expected under competition because competition requires that parties enter into exchanges freely. In many markets, this condition is not satisfied — nor can it be satisfied merely by deregulation.

Where exchanges are not freely entered, the competitive process only serves to reveal customers' willingness to shop around rather than their willingness to pay. Competition does not act to meet the preferences of customers. Instead, it allows service providers to price their services according to customers' willingness to shop around. Customers who are unwilling (or unable) to shopping around will pay higher prices than those who are shopping around.

This price differentiation is not equivalent to the price discrimination described in textbooks and it is not welfare enhancing. It does not lead to more being consumed by a broader suite of consumers. It merely represents a transfer from one group of customers to another. There is no rationale for outsourcing to service providers the power to determine such transfers; and there is certainly no rationale for such transfers to be made on the basis of willingness to shop around — as opposed to, say, capacity to pay. 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.

Because customers do not have the option of not consuming in these markets, they cannot express their dissatisfaction in the normal way. Nonsumers, as they're called in this paper, cannot walk away from the market. Unlike consumers in other markets, nonsumers do not have the option of not making a purchase no matter how much prices increase or how poorly they're serviced.

With limited options available to them, it is not surprising — indeed, it is quite predictable — that nonsumers will express their dissatisfaction politically rather than commercially. In this sense, political oversight and regulation of nonsumer markets is endogenous to the structure of these markets. While it may be convenient for some to claim that competition would operate perfectly well but for these interventions ("bad politics getting in the way of good economics"), nonsumers know better.

This explains the constant media coverage and political interest directed at particular markets, for example: retail energy, banking and other financial services, fuel, superannuation, health- and life insurance.  Each of these markets involves some degree of 'nonsumption' so this interest should be seen as endogenous and predictable.

Nonsumers cannot be made into consumers by mere decree. While making it easier for nonsumers to shop is always likely to be a worthwhile pursuit, constantly reminding them of the need to do so may not be welcome.

History suggests that policy makers have always known that it is not enough just to rely on nonsumers shopping around. Industry-specific regulatory frameworks have been in place or many years in the markets occupied by nonsumers. The ongoing (and increasing) political interest in these markets suggests that current regulatory arrangements are not adequately addressing the consequences of competition in these markets.

Innovation may circumvent the shortcomings of allowing competition in markets where exchanges are not entered into freely. But it may not. It may happen quickly. Or it may not. It may be widely available. Or it may be limited only to those with sufficient financial resources. In the meantime, the disutility of constantly having to shop around to avoid exploitative prices bears down on nonsumers. And, they rightly demand a response from those entrusted to promote their long term interests.

New thinking and new approaches are needed. The answer will not be found in doing more of the same and hoping for a different outcome. While caution is wise, denial is not. Nonsumers are demanding a response. The regulatory community has little option but to heed those calls if it is to remain relevant and respected.

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