

Consumers Command Power

Director's Letter Catherine Waddams

CCP's increasing focus on the role of consumers in competition and regulation policy is shown by the articles in this newsletter. We report on two major pieces of research undertaken for and published by government agencies: Luke Garrod and Morten Hviid explore appropriate remedies in consumer markets for the OFT; and Michael Harker and Judith Mehta benchmark the empowerment of UK consumers against those in six other leading countries for BERR. These two projects arise directly from CCP's research in this area, illustrated by my reflection of work with Tina Chang on what lies behind consumers' (in)activity in markets; and Pinar Akman's discussion of the concept of consumer welfare in the context of Article 82EC. Robert Sugden shows how this focus on consumers is consonant with more general and popular interest; we are delighted that he will be joining the Centre on a regular basis next year, working with Graham Loomes and others to address these issues further. We also report on our public events, which yielded important insights into the interpretation of our research findings.

End-of-project presentations at OFT, BERR and the Competition Commission included a CCP research 'double bill', coupled with a summary of the findings on 'Mergers and Merger Remedies in the EU' by Bruce Lyons and Steve Davies, published by Edward Elgar in January.

The book was generated by a research project commissioned by the EC - another excellent example of the translation of CCP's work with policy makers into output which is relevant both to practitioners and academicians.

Two of our post-doctoral fellows have moved on: Andrei Medvedev to the Financial Services Authority, and Liza Lovdahl Gormsen to concentrate on writing her book. Hieu Tran leaves us as a research associate (but continues as a PhD student in CCP) and we welcome Anupa Sahdev, who is taking a year out from her studies at Oxford, in his place. Bjørn Olav Johansen joins CCP for one year as a visiting student from Bergen University's Institute of Economics and we welcome 13 masters students in Industrial Economics and Competition Law.

CCP hosted the first CLEEN 'new researchers' workshop in June, and held its annual summer conference in July, this year on the interaction between competition and other policies (more details about both events on our website). This seems particularly timely in view of the financial turmoil in autumn 2008, and the UK government's rapid 'rescue' of banks without recourse to the usual competition safeguards. As recession develops and firms face difficulty, the protection of vigorous competition policy and CCP's work on competition and regulation will become even more relevant.

Choosing the Best Energy Deal for You

Hieu Tran, Researcher and PhD student, and Cheryl Whittaker, Communications Coordinator

The ESRC Festival of Social Science

In March and August we left our concrete campus to offer advice to members of the public on switching energy supplier; our research on consumer switching¹ shows that consumers often fail to appropriate the maximum savings available, so we wanted to offer some practical help. As part of the ESRC's Festival of Social Science, CCP held two events in March. Based on our own research findings, we asked members of the public about their energy expenditure, and then used a price comparison site with their details to see if

savings were possible. In March, we found average potential savings of around £177 per year for energy bills.

CCP and the Public

We held another event in August, after another round of price rises and substantial press coverage, and found many more people in need of guidance. This half-day event was hugely popular, with more than 100 members of the public seeking advice. We couldn't speak to everyone who attended, so we offered a 'postal service' to those who we weren't able to help on the day.

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Table 1: Summary of Savings over Two Sessions

	Average	Std. Dev.	No. of consumers
Mar-2008	177	106	70
Aug-2008	244	148	83
Total	213	134	153

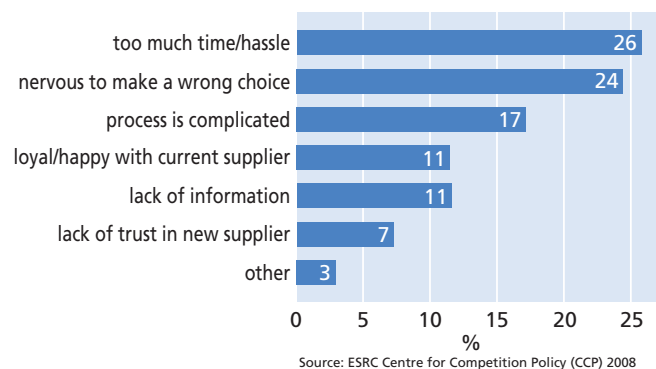
Table 1 shows average potential savings had increased since March as a result of further price increases.

Repeating the event in August gave us the opportunity to benefit from our experience in March. To discourage any bias in response, we asked householders not only why they themselves hadn't switched, but also, more generally, 'Why do you think people tend not to switch supplier, even when they know they can save money?' With this second question we hoped to encourage respondents to reflect more honestly on what may lie behind their own lack of consumer activity in the energy market.

Consumer Inertia

One very common (and honest) answer was consumer inertia: people are busy and get stuck in a routine. Perhaps more serious, though, were other answers: respondents cited lack of trust in companies (both current and new), lack of conviction in their decisions, and difficulty in comparing rival prices and tariffs. Figure 1 shows the seven most common responses to this question.

Figure 1: Why Do You Think People Tend Not To Switch Energy Supplier?

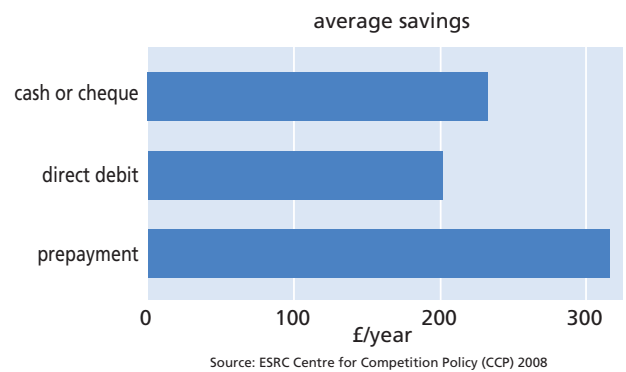


Too much time or hassle to switch is the major reason people cite for staying with their current energy supplier(s). People not only showed lack of confidence with the potential supplier (7%) but were also nervous about choosing the best supplier (24%).

Substantial Savings by Payment Methods

We found that a person's current payment method has a bearing on how much they can save by switching. Figure 2 makes it clear that those with prepayment meters could save a significantly larger amount than those paying by direct debit, even without changing their payment method. Since prepayment is usually the most expensive method, most consumers paying this way could save even more by switching to direct debit.

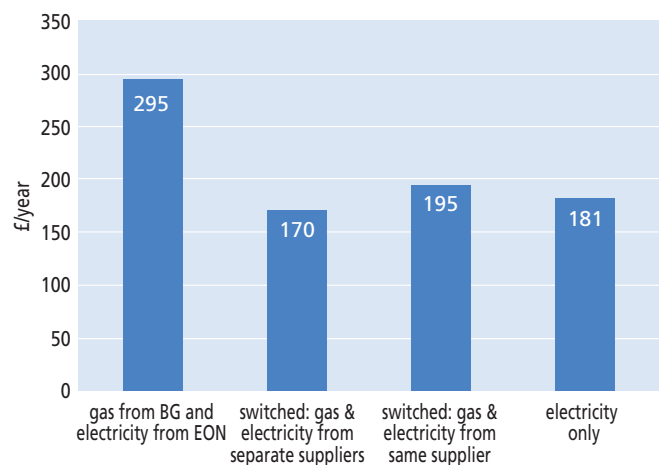
Figure 2: Savings by Method of Payment



Experience of Switching

We compared the potential savings for those who hadn't switched before and were still with the incumbent with those for consumers who had already switched one or more suppliers (Figure 3). On average, those who hadn't switched could save nearly £300 a year on their energy bills, compared with £186 for those who had already changed supplier. Rather surprisingly, there was no significant difference between the 75 previous switchers who already had a dual fuel discount, and the 43 who were still taking their energy from separate suppliers (at least one of whom was not the incumbent). Since Norfolk is a rural area, 30 of those who consulted us used only electricity; the average potential saving for this group was just over £180.

Figure 3: Potential Savings according to Current Suppliers



These results confirm findings by both the regulator Ofgem and CCP² that the initial switch away from the incumbents offers the greatest savings. Incumbents' charges remain higher than those of entrants, taking advantage of consumer inertia. Other CCP research found that the average mark-up in electricity was around 10% in early 2007,³ though Ofgem reports that this margin has reduced to around 6% after the most recent price rises. Even though the 'second switch' may be less profitable, it still offered substantial savings, suggesting that it may be worthwhile for consumers to keep an eye on the market, even after they have changed away from the incumbent suppliers.

Future Research

As well as using the outcome of our research to help consumers save money and become more active in the market, the contact with consumers has added an important dimension to CCP's research. Many of those who sought our advice travelled a considerable distance and had already undertaken painstaking research on better deals. Out of the 153 who visited us in the spring and summer, 9 could be reassured that they were already on the best available deal for them, but most were looking to boost confidence in their own findings about available savings before they made the change. Exploring the role of confidence in consumers' switching process will be a major part of CCP's future research on consumer activity in markets



¹ Wilson, Chris M. and Waddams Price, Catherine, 'Do Consumers Switch to the Best Supplier?', CCP Working Paper 07-6 (July 2007)

² Chang, Yoonhee Tina, and Waddams Price, Catherine, 'Gain or Pain: Does Consumer Activity Reflect Utility Maximisation?', CCP Working Paper 08-15 (February 2008)

³ Waddams, Catherine, Akman, Pinar, Harker, Michael, and Pham, Khai, 'Pros and Cons of Prepayment Meters' - a report for Energywatch, May 2007

The Benefits of Active Consumers

Luke Garrod, Post Doctoral Fellow, and Morten Hviid, Professor of Competition Law

Earlier this year, CCP produced a report commissioned by the OFT. It investigates the role that consumers play in markets, how this role is sometimes limited, and how recognition of this might affect the way in which remedies are constructed.

Where there is competition in a market, firms strive to attract custom by meeting the wants and needs of consumers more effectively than their competitors. Such competition can provide consumers with low prices, high quality, wide variety, and new and innovative products, while firms delivering this will be rewarded by more custom and higher profits.

If consumers were unwilling to be active in the market by searching out the best deals and reacting to them through switching, firms would have a local monopoly over their current consumers. This occurs first because no firm would be constrained by its rivals' behaviour since consumers would not react to it, and second, because no firm would have a

unilateral incentive to improve its offering to the consumer as this would not attract new sales from its rivals.

The OFT and the UK Competition Commission both design remedies in situations where markets fail to work well for consumers. These remedies can be aimed at protecting consumers, at making consumers more active, or at enabling (some) firms to communicate more credibly with consumers.

In policy terms, the emphasis to date has been on activating consumers directly by making it easier for them to acquire the necessary information, or indirectly by offering firms the means of communicating credibly and truthfully with consumers. The latter may be surprising, but there is some empirical evidence that demonstrates that firms may be better than third parties - such as government departments and consumer protection agencies - at communicating with consumers. For example, Ippolito and Mathios¹ examine changes in consumption during two regulatory regimes in the USA. One regime was characterised by attempts by third parties to educate the public about links between fats and disease risks. The other gave firms incentives to provide this education themselves through advertising and labels. Their main finding was that, while consumers responded to information flows throughout the two periods by reducing their fat consumption, the rate of change of fat consumption was higher when the information was provided by the firms. It is therefore worth speculating about what can be achieved through incentivising firms to provide accurate and useful information to consumers - for example, as part of a set of remedies imposed by a competition authority.

The 'Unravelling Principle'

The 'unravelling principle' suggests that firms have an incentive to provide consumers with complete information about their own products, if there are relevant differences between products, and if firms can make credible statements about these. If no firm revealed the relevant information, consumers would assess all firms as 'average' in terms of what they offer. Therefore, the firm offering the best terms has an incentive to disclose its information to consumers in order not to be considered average. Among any group of firms yet to reveal information, there is a firm that is 'best among the rest', which is hurt by being considered only average among the rest and which therefore also discloses information. This unravelling occurs until there is one firm left (that offers the worst deal on the market), and consumers correctly infer its quality from its silence. Moreover, this logic does not depend on the number of rival producers.

However, the unravelling principle rests on the assumption that the truthfulness of revealed

information can be verified either directly by consumers or at least by a trusted third party. Consequently, the principle suggests that a powerful remedy may be to help firms make credible statements so that they are able to communicate with their consumers. It may not be as effective when some of the assumptions on which it is based are relaxed: if disclosure or acquisition of information is costly, the provision of information may be incomplete, or unravelling may not occur.

While there are some theoretical reservations about the power of the unravelling principle, the empirical evidence is more positive, providing evidence that the unravelling principle does exist in reality, although it rarely works perfectly. For example, Mathios² studies the impact of mandatory labelling in the USA on salad dressing during a change to the laws governing that food products must display labels. Before the law changed, displaying nutritional labels was voluntary (although regulation ensured that any statement on a label had to be truthful) and, as a result, all low-fat salad dressings included a label, while the majority of the high-fat products did not. After nutritional labels became mandatory, the highest-fat dressings experienced a significant loss of market share as consumers made more informed choices over the fat content of their salad dressing.

Policy interventions that enable firms to make credible statements about features of their product which consumers care about may thus prove powerful. However, in the assessment of such a policy, the cost of monitoring, verifying and enforcing the veracity of such statements must be factored in.

Searching for Information

If firms or government agencies do not provide the relevant information, the onus is on consumers to find this out for themselves. The problem here is that it can be costly (in terms of money, time and effort) for consumers to gather price and non-price information about goods and services. From the consumer's perspective, the perceived benefits from searching are outweighed by the expected costs of searching.

A robust result obtained in theoretical search models is that the average price in the market falls as the proportion of consumers willing to search the market increases or the cost of search decreases. Remedies which act directly to reduce real search costs have the most potential by increasing both the proportion of searchers and the extent of each search.

Price Comparison Sites

At first sight, the Internet would seem to provide answers to the problem of searching involving complex products. While there is evidence that price comparison sites can help, there is also evidence that consumers may not be willing to spend time to find the best deal. In addition, the fact that price

dispersion remains on such sites indicates that the ability for consumers to compare instantly does not in itself generate a 'perfectly competitive' outcome. Price comparison sites, operated by a regulator or a private company, at least provide consumers with a list of prices for similar products that are available from multiple firms and, in some cases, with additional information such as total expenditure. The ability to search the market with a single click of a mouse has the potential to radically reduce search costs as consumers can quickly locate the best deal, which can intensify competition. While one might expect that the Internet would intensify price competition, and even lead to the 'law of one price', current research suggests that this belief is optimistic, despite robust evidence that price comparison sites have lowered prices.

There are several reasons why price competition may not lead to the 'law of one price'. One explanation is that consumers may be unwilling to purchase from the lowest-priced firm if it is an unknown brand. The OFT³ suggests that consumers are willing to pay a premium for goods at a 'bricks and clicks' retailer compared with a retailer that is online only, as this provides more security if the product is faulty. Another explanation is that consumers may be unwilling to spend time and effort on checking each firm's offerings even though it can take just a single click of a mouse, instead focusing on the products that are most prominent.

Further Thoughts

There is another potential limit to the effectiveness of informational remedies - namely, the fact that consumers' time, attention and information-processing powers are themselves bounded and/or their preferences and motivations may be configured differently from the standard model. This may result in behaviour, including responses to the remedies themselves, which is difficult to explain or predict conventionally.

A secondary concern is that if consumers are fully insured from any mistakes they may make, whether through inadequate search, bad judgement or abusive behaviour by sellers, their incentives to be active are severely limited. The more consumers face the full force of bad decisions, the more one would expect to see them taking steps to minimise mistakes and to learn from the past. Where the cost of errors and of learning are not too large, restricting attention to general consumer education to help consumers help themselves may be a better way to make markets work well than measures to protect the consumer.

¹ Ippolito, P. and Mathios, A. (1995), 'Information and Advertising: The Case of Fat Consumption in the United States', *American Economic Review*, 85, Papers and Proceedings, pp.91-95

² Mathios, A. (2000), 'The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market', *Journal of Law and Economics*, 43, pp.651-77

³ OFT (2007), 'Internet Shopping', OFT Market Study, June

'Consumer Welfare' and Article 82EC: Practice and Rhetoric¹

Pinar Akman, Lecturer in Law

The EC Commission repeatedly states in its policy declarations that the ultimate objective of Article 82EC prohibiting the abuse of a dominant position is enhancing 'consumer welfare'.² In contrast, the term 'consumer welfare' has been used in only two competition cases by the Court of First Instance (CFI) and has never been referred to by the European Court of Justice (ECJ).³ This raises the question of whether the objective of Article 82EC is genuinely enhancing 'consumer welfare' when one considers the application of the provision by the EC Commission and Courts alongside the policy declarations of the EC Commission.

Unfortunately, one cannot pinpoint a clear test of harm based on 'consumer welfare' in the decisional practice of the EC Commission and Courts. This leaves Article 82EC as a provision enforced without an unambiguous standard of harm and raises doubts about the legitimacy of this enforcement. The discrepancy between practice and rhetoric makes one wonder whether 'consumer welfare' has merely become a slogan and in some cases a way of legitimising the decision of the authorities in the name of 'consumers'. Moreover, the discrepancy deprives the undertakings of *ex ante* business certainty as there is no well-defined test of 'abuse'. Further, it leaves the EC Commission prone to the criticism of 'protecting competitors, not competition' which goes against its aspiration to modernise the application of Article 82EC by adopting a more economic effects-based approach.

Practice and Rhetoric

The rhetoric is straightforward: especially during the EC Commission's ongoing review of Article 82EC, it has been repeatedly stated that enforcement of this provision should focus on conduct that has actual or likely restrictive *effects* on the market and so harms consumers.⁴ The objective of Article 82EC has been expressed as protecting competition in the market, not for its own sake, but rather as a means of enhancing 'consumer welfare' and ensuring the efficient allocation of resources.⁵

The practice is not so straightforward: it is impossible to identify a coherent and unified approach to the standard of harm under Article 82EC. Thus, it is difficult to determine whether and how 'consumer

welfare' plays a role in the enforcement of Article 82EC. Although this is a question of objectives and is fundamental if enforcement is to serve the appropriate objectives, it is surprisingly unsettled.

As regards the standard of harm, two aspects are important: first, whether the finding of 'abuse' has to be based on (actual or likely) *effects* of conduct; and second, who or what is the subject of abusive conduct, i.e. whether it is competitors, consumers or else that must be affected by conduct.

Concerning the necessity of a showing of anticompetitive *effects*, the decisional practice is inconsistent. On the one hand, several cases indicate that there must be a concrete assessment of a practice's effects on the market before a finding can be made.⁶ On the other hand, there are cases which find that anticompetitive *object* or *potential* restrictive effects are sufficient to prove an abuse.⁷ For example, the effects of conduct were not deemed relevant at all in cases such as *Michelin II* and *Irish Sugar*: the CFI held that for the purposes of applying Article 82EC, establishing anticompetitive object and anticompetitive effect are one and the same thing.⁸ Accordingly, it is sufficient to show that the abusive conduct of the dominant undertaking tends to restrict competition or, in other words, that the conduct is capable of having that effect.⁹

Yet, finding conduct abusive when it is *capable of* having an anticompetitive *effect* is very different from finding it abusive merely on the basis of alleged anticompetitive *object*. Unlike Article 81EC, the provision of Article 82EC does not sanction anticompetitive *object*. Moreover, as in the example of predatory pricing, even if the undertaking has the *object* to abuse its position, a failed attempt at 'abuse' can benefit consumers and the *effect* would not be anticompetitive under a 'consumer welfare' standard.

As for the second limb of the question, namely who or what the abusive conduct must impact upon for finding breach of Article 82EC, it is again not easy to discern an unequivocal understanding. Although the avoidance of harm to consumers is seen as the ultimate concern of the provision in the Discussion Paper of DG Competition,¹⁰ the test proposed therein does *not* seek proof of any actual or possible harm to consumers. Moreover, if the EC Commission is moving towards a 'consumer welfare' standard, then it has a peculiar understanding of 'consumer welfare': the EC Commission treats 'consumer welfare' and 'efficient allocation of resources' as separate concepts.¹¹ Thus, its 'consumer welfare' concept does not refer to allocative inefficiency (the deadweight loss). From an economic perspective, this leaves only the 'wealth transfer' from consumers to producers. This is odd given that elsewhere the EC Commission has expressly

stated its wish not to pursue 'unfair pricing' cases which are logically the cases it should first and foremost pursue with this perception of 'consumer welfare'.¹² Such an understanding of 'consumer welfare' would require serious scrutiny of prices in the market; the desirability of this is very questionable.

All in all, it will be the EC Courts that will have the last say on the standard of harm under Article 82EC. Unfortunately, it is not at all clear from the case law so far whether the Courts have any unified standard while applying Article 82EC and it is especially doubtful whether they will adopt a properly defined 'consumer welfare' standard or require consumer harm to be demonstrated for a finding of abuse.

For example, the CFI has held that Article 82EC prohibits a dominant undertaking from eliminating a competitor and from strengthening its position by recourse to means other than those based on 'competition on the merits'.¹³ Further, it found that '[t]he prohibition laid down in that provision is also justified by the concern not to cause harm to consumers'. Thus, it is obvious that not causing harm to consumers is not the ultimate justification of Article 82EC, but it is also a legitimate concern. Similarly, Advocate General Kokott argued in *British Airways* that Article 82EC, like the other EC competition rules, is not designed only or primarily to protect the immediate interests of individual competitors or consumers, but to protect the structure of the market and thus competition as an institution.¹⁴ The ECJ in *British Airways* repeated its position in *Continental Can* that Article 82EC is aimed not only at practices which may cause prejudice to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure.¹⁵

Reconciliation between Practice and Rhetoric

The only thing that seems clear enough in the area of the standard of harm under Article 82EC is the dissonance between practice and rhetoric. Although 'consumer welfare' is declared to be the ultimate goal of EC competition rules, the decisional practice does not convincingly support this. There is a lack of consensus between the EC Commission and Courts and a lack of coherence within the application of Article 82EC by the EC Commission, especially when one compares it with its policy declarations.

To reconcile its practice with its rhetoric the EC Commission either has to unambiguously demonstrate in its decisions that it follows a well-defined 'consumer welfare' approach, or it should unambiguously declare what approach it follows in practice. Then, it is for the Courts to endorse this. Overall, it is questionable whether mere *likelihood* of anticompetitive harm

should be sufficient for a finding of abuse when one recognises that 'abuse' requires the *use* of power and Article 82EC is a tool of *ex post* intervention. When the *likelihood* of anticompetitive harm is deemed sufficient, it remains to be answered when effects should be deemed so *likely* that intervention is justified. So far, it remains unknown what the required probability is for *likely* effects to warrant intervention.

In the literature, it has been suggested that harm to an 'effective competitive structure' and consumer harm should amount to the same thing: unless there is consumer harm, there is no relevant harm to the 'structure of competition'.¹⁶ There can be no case for intervention under competition law where there is harm to the competitive process, but none to consumers.¹⁷ Similarly, mere consumer harm should not be enough on its own for conduct to be abusive. If the standard is 'consumer welfare', then harm to consumers resulting from a restriction of competition should be the test for finding conduct abusive under Article 82EC. As such, requiring both harm to competition and harm to consumers to find conduct abusive can help to correct the dissonance between the practice and rhetoric on the standard of harm under Article 82EC. Currently, Article 82EC remains an area of law with more questions than answers.

¹ This article draws on CCP Working Paper 08-25, of the same title, which can be found at <http://www.ccp.uea.ac.uk/publicfiles/workingpapers/CCP08-25.pdf>.

² EC Commission 'DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses' (Brussels, December 2005) [4], [54], [88]; N Kroes, 'Preliminary Thoughts on Policy Review of Article 82' Speech at the Fordham Corporate Law Institute, New York, 23 September 2005, 3. This article adopts the common understanding of 'consumer welfare' in economics, i.e. 'consumer surplus' which is the aggregate measure of the surplus of all consumers.

³ This is based on a Westlaw search of 'consumer welfare' as a 'term' in 'EU cases' (conducted on 21.07.2008). The two cases are Case T-168/01 *GlaxoSmithKline Services Unlimited v EC Commission* [2006] ECR II-2969 and Case T-201/04 *Microsoft Corp v EC Commission* [2007] 5 CMLR 11. In *Microsoft* the CFI merely refers to the Commission decision using the term; *ibid* [41]. 'Consumer welfare' is also referred to in the Opinion of Advocate General Jacobs in Case C-53/03 *Synetairismos Farmakopoiion Aitolias & Akarnanias (Syfait) and Others v GlaxoSmithKline plc and GlaxoSmithKline AEVE* [2005] ECR I-4609, [91], [92].

⁴ See Kroes (n 2); Discussion Paper (n 2) [4].

⁵ Kroes (n 4) 3.

⁶ See Case T-65/89 *BPB Industries plc and British Gypsum Ltd v Commission* [1993] ECR II-389, [65]-[66]; Case T-65/98 *Van den Bergh Foods Ltd v Commission* [2003] ECR II-4563; Case T-83/91 *Tetra Pak International SA v Commission* [1994] ECR II-755, [151]. Similarly EC Commission decisions such as *ECS/AKZO 85/609/EEC* [1985] OJ L374/1, [86]; *Deutsche Post AG 2001/354/EC* [2001] OJ L125/27, [37] et seq.

⁷ See Case T-203/01 *Manufacture Francaise des Pneumatiques Michelin v EC Commission* [2003] ECR II-4071, [239]; Case T-219/99 *British Airways plc v Commission* [2003] ECR II-5917, [293]; *Deutsche Telekom AG 2003/707/EC* [2003] OJ L263/9, [179]-[180].

⁸ *Michelin II* (n 7) [241]; Case T-228/97 *Irish Sugar plc v Commission* [1999] ECR II-2969, [170].

⁹ *Michelin II* (n 7) [239]. Similarly *British Airways* (n 7) [293].

¹⁰ Discussion Paper (n 2) [4], [54]-[55], [88].

¹¹ Discussion Paper (n 2) [4], [54], [88]. See also EC Commission Guidelines on the Application of Article 81(3) of the Treaty [2004] OJ C101/97 [13].

¹² See European Commission XXIVth Annual Report on Competition Policy (1994) [207].

¹³ *Van den Bergh* (n 6) [157].

¹⁴ Opinion of Advocate General Kokott on 23 February 2006 in Case C-95/04 *British Airways plc v EC Commission* [2007] ECR I-2331, [68].

¹⁵ *British Airways* (n 14) [106]. Case 6/72 *Europemballage Corp and Continental Can Co Inc v Commission* [1973] ECR 215, [26].

¹⁶ R O'Donoghue and AJ Padilla *The Law and Economics of Article 82 EC* (Hart Publishing Oxford 2006) 221; J Vickers 'Abuse of Market Power' (2005) 115 *The Economic Journal* F244, F259.

¹⁷ O'Donoghue and Padilla (n 16) 221-222.

Why Do(n't) Consumers Switch Supplier?¹

Catherine Waddams, Director of CCP and Professor in Norwich Business School

Given the considerable gains available from switching provider of energy, telecommunications services and financial products, why do so many consumers stick to their current supplier? Tina Chang and Catherine Waddams have questioned how far consumers' switching decisions are 'rational' in the sense that they are determined by their expected gains from switching, and how long they expect the total process to take.

Consumers play a central role in making markets work well, and consumer authorities and governments are increasingly interested in maximising the positive influence which consumers can have in disciplining market suppliers. Our findings are based on a specially commissioned large-scale survey administered in the summer of 2005, before the recent soaring energy prices and turmoil in the financial markets which may have influenced switching behaviour.

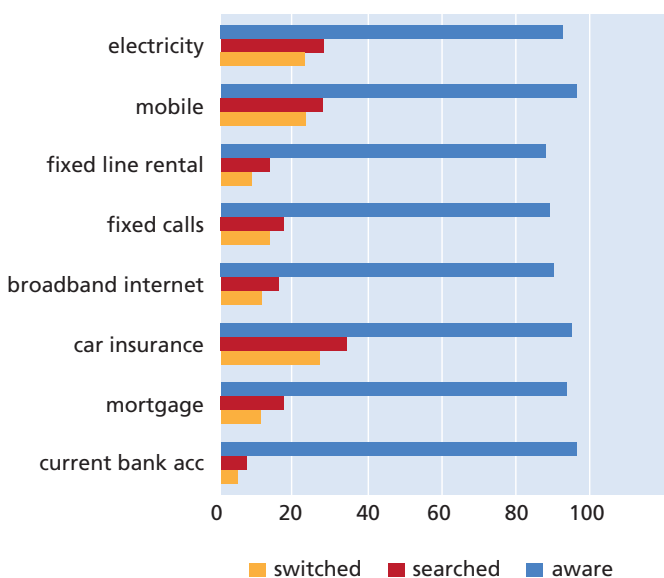


Figure 1: Switching activity across markets.

The survey was carried out among a nationally representative sample of 2,027 adults, interviewed face-to-face in their own homes across the UK (excluding Northern Ireland) and coordinated at CCP by Tina Chang. Respondents were asked which products the household consumed and paid for from a list including gas and electricity, fixed and mobile phone services, internet service provision, house contents insurance, car insurance, mortgage, current bank account and piped water supply. Amongst these, they were then asked whether they had a choice of supplier for each product in their region, as a means

of testing their awareness of competition in the market. Virtually all who were interviewed had a choice for all products, except for water where no choice is available. Respondents were selected for the next stage of the survey if they were aware that choice was available in the relevant market and they were solely or jointly responsible for making decisions about who supplied that product. The chart shows that most consumers were aware of choice in each market, and that switching rates ranged from 4% for current bank accounts to 25% for car insurance.

Further questions were asked about all these markets except water, gas and house contents insurance. In particular, respondents were asked whether they had searched around for better deals and whether they had switched supplier in each market during the previous three years (other than when moving house). They were asked how long such search and switching had taken, or how long they would expect it to take; and how much they thought they could save in each market if they shopped around. The analysis focused on the expectations which consumers themselves hold about the time needed to search the market to find the best deal and then switch to an alternative supplier, and the potential monetary gains from changing supplier, rather than relying on external measures of these costs and benefits from switching.

We find that consumers do indeed exhibit the rational behaviour which classic economic modelling would suggest. Those who thought the potential gains were higher and it would take them less time to search and switch were more likely to change suppliers. Inactive consumers might therefore be motivated to become more active by greater potential rewards and reductions in the time they expected to have to invest in searching around for the best deal and making the switch.

However, the influence of a consumer's expected gains and costs provide only a very small part of the explanation for the probability that they will be active in a market. The confidence with which consumers predict their likely gains and costs seems to be much more influential in determining whether or not they will switch. This is supported by evidence from energy roadshows held by CCP in March and August 2008 as household prices were rising in 2008 (see pages 1&2 of this newsletter). Many consumers, offered impartial advice on the cheapest energy supplier for their circumstances, had already undertaken considerable research for themselves, and had a good idea of the best deal available. But they went to some trouble to seek confirmation of their choice from an impartial source.

The survey enables us to identify both how each factor affects consumers' overall activity, and to

distinguish whether it is search or switching decisions which are affected. While similar factors affect the decisions to search and to switch, their influence on the two activities is not always identical. Expected gain (with age) is more likely to stimulate searching than switching; expecting to spend an extra hour switching appears to have a greater deterrent effect than a similar burden for searching.

The U-shaped effect of age is similar for both search and switching: the middle-aged are less active than both their younger and older counterparts.

Experience of switching supplier in other markets increases the likelihood of search more than that of switching. Since we have a direct measure of expected search time we are able to interpret the importance of experience of activity in other markets as increasing the confidence which consumers place in their central estimates of time needed and likely gain rather than affecting those estimates directly.

Even allowing for the different potential gains, expectations about search and switching time needed, attitudes, characteristics and experience of consumers, the probability of switching varies substantially between markets. Taking account of all the other factors, consumers are more likely to be active in the car insurance market than in electricity and mobile phones; and less likely to search and switch for fixed line services, broadband, mortgages and current bank accounts. The market effects are large, raising the probability of any one consumer's activity by 9% in the car insurance market relative to electricity, and lowering it by 20% for current bank accounts.

We conclude that consumers' decisions to become active in a market can be partially explained by higher expected gains and lower anticipated costs in switching supplier. This provides some justification for the optimism of Competition Authorities in imposing information remedies to encourage consumer activity. However, the influence of a consumer's expected gains and costs, even when measured individually for each person (rather than based on external assessments), is swamped by other factors in explaining the level of activity in any market. Experience of switching in other markets exerts a strong positive influence, which we are able to interpret as reducing the variation of a consumer's estimate, rather than affecting its central value. To encourage activity in any one market, competition authorities need to provide consumers with good information, in which consumers have confidence, about the likely costs and benefits. This will provide positive externalities for other markets, building further confidence through experience.

The significant and substantial differences between markets do suggest differential approaches. All the

markets included in this study are subject to sector regulation: from the Office of Gas and Electricity Markets (electricity); the Office of Communications (mobile and fixed line phone services and broadband); or from the Financial Services Authority (car insurance, mortgages and bank accounts). The greatest propensity to switch is in the car insurance market, though the influence of anticipated savings from switching is particularly small in this market. Car insurance is the only market in our sample where annual reminders for renewal are required, even if the consumer need take no action to stay with the current supplier. Such reminders do seem to prompt some consumer activity, and competitors may target advertising at the time of contract renewal. Regulators might wish to consider imposing similar reminders in other markets, though they would need to balance potential gains against the cost of the exercise to both providers and consumers. But overwhelmingly it seems consumers are looking for an authoritative independent source of information. Comparison websites are an obvious tool to help in this process, but consumers often lack confidence in their independence. Regulation to increase consumers' confidence in the independence of such information might go a long way to make consumers more confident and active in these markets.

¹ Based on CCP Working Paper 08-15, 'Gain or Pain: Does consumer activity reflect utility maximisation?', available at <http://www.ccp.uea.ac.uk/publicfiles/workingpapers/CCP08-15.pdf>

CCP 5th Annual Conference: Cartels and Tacit Collusion 18 - 19 June 2009 UEA

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Identifying and Evaluating the Level of Consumer Empowerment

Michael Harker, Lecturer in Law, & Judith Mehta, Research Coordinator

Introduction

Consumer empowerment is a term which is increasingly used in the policy arena. Empowered consumers are regarded as 'good' consumers for two reasons: first, they are seen as well placed to secure the best possible outcomes for themselves, which is, of course, to their own benefit; second, they are understood to exert a discipline on the behaviour of firms, which is to the benefit of all consumers. A high level of consumer empowerment, then, is something for policy makers to aim for.

Yet while most of us have an intuitive understanding of 'consumer empowerment', practical application of the term in the policy arena raises a key question: by what means can it be *systematically* identified and evaluated? This and other questions have been central to a study commissioned by the Department for Business Enterprise and Regulatory Reform (BERR) and recently completed by a team of researchers from CCP.¹

Benchmarking the UK Consumer Regime - a 'Top-Down' Approach

The study benchmarked the performance of the UK framework supporting consumer empowerment by comparing it with the frameworks of six other countries: Australia, Canada, Denmark, Germany, Spain and the US. It was expected that amongst these comparators would be found some of the best practices with respect to consumer protection and empowerment.

The notion of consumer empowerment can be distilled into the following:

- Empowered consumers are capable of making *informed choices*, which in turn requires a regime to put in place the tools for consumers to secure the best possible outcomes for themselves.
- Consumers should be *capable and willing to assert their rights*, which requires that a regime has laws and institutions which are sufficiently transparent, accessible and responsive to their needs.
- To the extent that consumer empowerment is outcome-driven, the regime ought to be capable of *identifying features of the market which impede the realisation of consumer benefits or cause consumer detriment*, and it should have the necessary tools to deal with such problems.

Consumer empowerment must embrace some notion of 'autonomy', especially since too much intervention

may cut across the core benefits of what markets can deliver. This issue is particularly germane when one considers the issue of whether a regime ought to provide special protection for disadvantaged consumers. The dilemma for policy makers is that protecting disadvantaged consumers may come at the expense of overall consumers' welfare (for example, by unduly restricting choice or increasing product costs). Nevertheless, there are a number of interventions which can empower all consumers and, perhaps, the disadvantaged in particular (such as reducing search costs). In sum, we conclude that a consumer empowerment regime should improve outcomes for all consumers, but some measures will have a particularly positive impact on disadvantaged consumers.

Consumer Interface

Information and advice are key to consumer empowerment. Given the complexity of consumer law, consumers are unlikely to have a full awareness of their rights before entering into a transaction (indeed, there is evidence that some consumers overestimate their legal rights). Perhaps more important than an awareness of rights is the provision of visible consumer advice channels which are accessible, strongly branded and based on the one-stop shop principle. According to our research, most countries were focusing resources here, although the types of provision did differ to some extent; telephone helplines were the most prevalent, with more limited evidence of internet and face-to-face provision. Against this measure we concluded that the UK performs well. The Consumer Direct advice line, funded by government, displayed high levels of consumer satisfaction. There is also face-to-face provision provided through CABx, which is viewed as benefiting disadvantaged consumers in particular.

Strong consumer representation is necessary for several reasons: it enables regulators to respond to diverse consumer interests, can provide important intelligence on markets, assists agencies in setting priorities and targeting resources, and may highlight the especial problems of disadvantaged consumers (who are least likely to complain). All jurisdictions appear to make provision for consumer representation, and again the UK performs well - especially with the recent streamlining and enhanced powers/visibility of the NCC ('Consumer Focus' from 1 October 2008).

Redress Mechanisms

An empowered consumer needs to be reasonably confident that there will be realistic redress mechanisms in place should things go wrong. There are serious impediments to consumers pursuing litigation given the typically low levels of harm and the cost and risks involved with recourse to the courts (even small claims). Provision of simple, low cost Alternative Dispute Resolution (ADR) can promote confidence among

consumers and is likely therefore to promote empowerment. We found that coverage of ADR in the UK was patchy, and some markets with low levels of consumer satisfaction have no provision. Other countries could be used as an example in this regard, such as Denmark, which has a default mechanism where there is no (private) scheme in place.

Public Enforcement

There is an important role for public enforcement. Resources need to be targeted (where detriment is greatest) and monitoring of outcomes is important. In some cases, there is a need for market level interventions (i.e., the imposition of a remedy even though there is no specific breach of consumer law). The UK's public enforcement regime performed well. There was evidence of monitoring, and market level interventions are available uniquely in the UK under the Enterprise Act 2002. The use of market-specific remedies has also the benefit of avoiding 'over-regulation', and can be used to deal with specific markets which impact on disadvantaged consumers.

Evaluating Consumer Outcomes - a 'Bottom-Up' Approach

Consumers may be well provided with relevant information, their interests may be well represented by consumer advocacy groups, and a variety of mechanisms may exist for dealing expeditiously with complaints in the event that problems arise; but the ultimate test of a regime is whether those attributes which appear positive on paper translate into good quality outcomes for consumers.

A review of the economic literature identified 14 theoretically-driven indicators with empirical 'grip' on the level of consumer empowerment. Where one or more of these indicators identifies a market as one in which consumers are likely to be disempowered, it is not necessarily the case that consumers will experience detriment. Indeed, it is possible for disempowered consumers to achieve good outcomes where there is effective regulation; and, conversely, empowered consumers may achieve poor outcomes in the face of coordinated effects on the supply side. But application of the indicators does point to those markets where, as a result of a degree of disempowerment, there is the *potential* for detriment and for consumers to experience poor quality outcomes in terms of the choice of products available to them, the quality of the goods they buy, the prices they pay, and other measures of outcome as appropriate to a given market.

Personal Bank Accounts

This was one of four case studies where consumer transactions were compared across the seven countries in the study set against the 14 market indicators.²

The market for personal bank accounts is characterised

by a number of different issues germane to the question of consumer empowerment - and in all of the countries in the study. The market is not one in which we are likely to find fully informed consumers: it is a market characterised by complex tariff structures and a lack of price transparency, making it difficult for consumers to compare products and identify the optimal one for them.

Yet the UK appears to perform better than comparator countries in some important respects. For example, UK consumers benefit from a higher level of transparency than most of their counterparts. Compared to consumers in many other countries, UK consumers have amongst the broadest range of services available to them. UK and US consumers incur similar levels of costs, but UK consumers arguably receive greater benefits. Moreover, UK consumers are reasonably well supported by institutional mechanisms, such as the Financial Ombudsman Service.

Methodological Issues

But whichever market is at issue, a strong imperative to emerge from the study is the need for data and for data of the right kind. Researchers found it was not always possible to evaluate the level of empowerment against one or more market indicators because of insufficient information. This finding chimes with one reached by the authors of the European Commission's 'Consumer Markets Scoreboard': complete, harmonised and comparable data on consumer outcomes is largely absent, and an important forward task must be to develop such data.³

But apart from identifying those markets in which there is the potential for detriment, the monitoring and evaluation of outcomes performs other important functions for a consumer regime concerned to embody best practice. In particular, the study reveals that not all interventions designed to raise consumer empowerment are wholly effective; this means there is a need to systematically monitor outcomes in order to establish the impact of intervention. Moreover, the study finds that monitoring (both of outcomes and of complaints) increases the compliance of suppliers, and it contributes to the efficient use of enforcement resources by sharpening the focus on problematic markets.

The methodology devised by CCP researchers is one which can be replicated and built upon by policy makers concerned with identifying and evaluating the level of consumer empowerment. If, as seems likely, sufficient data becomes available in the future, we may expect to observe a more systematic approach to the task of raising consumer empowerment and reducing consumer exposure to detriment.

¹ The Report is available at: <http://www.berr.gov.uk/consumers/policy/index.html>

² The other three market case studies were domestic energy supply, mobile phone services and car repairs and servicing.

³ European Commission, 2008, 'The Consumer Markets Scoreboard: Monitoring Consumer Outcomes in the Single Market', available at: http://ec.europa.eu/consumers/strategy/sec_2008_87_en.pdf

Do we Need to be Nudged?

Robert Sugden, Professor of Economics

A recent book about law and economics has created a stir in the United States, and has even appeared on a summer reading list for Conservative MPs. The book is *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Yale University Press, 2008). Its authors are two distinguished professors at the University of Chicago - Richard Thaler, who is an economist, and Cass Sunstein, who is a legal scholar. The book popularises the idea of *libertarian paternalism* that Thaler and Sunstein have previously presented in academic publications, and which had already aroused considerable interest among economists. Not believing in false modesty, Thaler and Sunstein present libertarian paternalism as the 'real Third Way' (p.252).

Libertarian paternalism is a response to a growing body of research in economics which imports theories and experimental methods from psychology, and which is showing that individual decision-making is rather less rational than economic theory has usually assumed. Thaler was one of the pioneers of this form of economics - now generally known as *behavioural economics*. (Since I do not believe in false modesty either, I must add that my UEA colleague Graham Loomes and I were pioneers in the same enterprise.) It is only relatively recently that behavioural economists have started to think seriously about the implications of their findings for public policy. Traditionally, economic policy advice has been based on the assumption that individuals act rationally within whatever constraints they face. Individuals have been assumed to have consistent preferences, and the satisfaction of those preferences has been taken as the appropriate criterion for evaluating alternative policies. But what if those assumptions are false? How then should economists set about giving policy advice?

One of Thaler and Sunstein's innovations is to introduce a new job description, that of 'choice architect'. A choice architect designs the interface between decision problems and decision makers. The idea behind the metaphor is that an architect has special expertise in designing buildings so that they 'work' for the people who use them. Significantly, architects are hired by clients who recognise that they do not quite know what they want from the architect's design. Analogously, we are told, a choice architect designs decision interfaces so that

individuals' choices work well for them.

Thaler and Sunstein start from the proposition that 'individuals make pretty bad decisions - decisions they would not have made if they had paid full attention and possessed complete information, unlimited cognitive abilities, and complete self-control'. Because of these limitations of human decision making, there is a role for choice architects. Thaler and Sunstein concede that they are recommending paternalism: 'The paternalistic aspect lies in the claim that it is legitimate for choice architects to try to influence people's behavior in order to make their lives longer, healthier and better'. But, they insist, their recommendations are designed to 'make choosers better off, *as judged by themselves*' (italics in original) (p.5). It is not altogether clear how the choice architect is to discover the choosers' judgements about what makes them better off, but presumably the principle is to try to reconstruct - or perhaps just to guess? - what the individual would have chosen, had she been subject to no limitations of attention, information, cognitive ability or self-control.

The libertarian component of the approach is the principle that choice architects must not significantly obstruct individuals' freedom of choice - they must rely on *nudges*. The idea is to take advantage of what behavioural economics has shown to be the malleability of people's decision making. Well-designed choice architecture steers people towards the choices that are in their best interests, while leaving them free to choose otherwise if they really want to. A good example - and a branch of choice architecture which Thaler has practised professionally - is the design of occupational pension plans. Thaler takes it as self-evident that, when contributions to such plans are voluntary, many workers save too little. His proposals are designed to nudge them towards saving more. One nudge is to make a substantial level of contribution the default plan for new employees, from which individuals can opt out if they so choose. A second, stealthier nudge is the 'Save More Tomorrow' plan, by which a worker chooses a default rate of contribution that is initially quite low, but which increases over time with salary increases (with a continuing opt-out provision). These nudges take advantage of normal human biases in favour of the status quo and the immediate present.

Thaler and Sunstein have a good deal to say about competition and regulation. They argue that, in many markets (their examples include mobile phones and credit cards) the complexity of tariff structures and the slowness of feedback make it difficult for consumers to make rational choices between competing suppliers. Firms may exploit consumers' cognitive limitations by creating unnecessarily complex tariffs, or

by loading charges onto service components that consumers tend not to find salient or (as in the case of charges for exceeding credit limits) do not anticipate using. Thaler and Sunstein propose forms of choice architecture that facilitate realistic price comparisons.

In particular, they propose a requirement on firms to give what they call RECAP (Record, Evaluate and Compare Alternative Prices) reports to their customers. A RECAP report is a personalised electronic summary of the customer's use of the firm's services, structured in a standardised way so that it can be combined with any other firm's tariff to show how much the same bundle of services would have cost if bought from that firm. Thaler and Sunstein's idea is that private websites would emerge to produce price comparisons for downloaded RECAP reports. (A more radical version of this proposal, suggested by Graham Loomes, is a legal requirement for each firm to provide personalised price comparisons along with its bills.) Such proposals are natural extensions of existing rules for standardising price information, such as the requirement to convert interest charges into annual percentage rates.

As these examples may suggest, many of Thaler and Sunstein's specific proposals are both sensible and ingenious (even if some specialists in competition and regulation may worry about whether RECAP reports would facilitate tacit collusion between firms). But I cannot avoid a feeling of unease about the general thrust of libertarian paternalism.

One of Thaler and Sunstein's favourite argumentative strategies is to claim that the findings of behavioural economics make paternalism inevitable - that any principled opposition to paternalism is 'a literal nonstarter' (p.11). What they mean by this is that if an individual's preferences are unstable or context-dependent, the traditional economic criterion of maximising preference satisfaction ceases to have meaning. For any decision problem, there has to be *some* choice architecture. If different architectures can be predicted to lead to different decisions, every architecture nudges people in one way or another. So (Thaler and Sunstein ask rhetorically) what sensible alternative is there to the principle of nudging people towards the choices that are best for them?

One source of concern here is that there are many cases in which individuals' preferences are context-dependent, but there is no clear and defensible criterion for judging the preferences revealed in one context as correct and the others as mistakes. Do you really want to say that, whenever *your* preferences fail to meet the unrealistic standards of rationality set out in old-fashioned economics textbooks, some 'choice architect' should nudge you in the direction that she thinks is best for you (or that she thinks you would have chosen, had you not been subject to what she

judges to be your cognitive limitations)? In my own work, I have tried to develop an understanding of consumer sovereignty that has value even for consumers whose preferences are context-dependent.

Implicit in the libertarian paternalist position is a faith in 'expert' judgement: as consumers, we are being asked to acknowledge our own irrationality and allow ourselves to be nudged towards doing what experts judge to be good for us. This kind of deference to expertise seems to me to be contrary to the spirit of our times. (Think of how attitudes to doctors, teachers, lawyers, clergy, scientists and politicians have changed over the last decades.) Why, then (you may ask) have Sunstein and Thaler's ideas struck a chord with so many readers? The answer, I suggest, is that when we think about paternalistic interventions, we all tend to imagine that those interventions will implement the views of experts who happen to agree with us, and that it will be other people who will end up being nudged.

Whatever one makes of libertarian paternalism, however, it is clear that economics needs to find ways of giving policy advice without assuming that individuals always act on consistent preferences. The experimental economists at UEA have been working on this problem for some time, both in general and in the specific contexts of competition policy and consumer protection. In April of this year, we held an international conference, co-sponsored by ESRC and CCP, to explore different strategies for reconciling behavioural and normative economics. Loomes and I hope to develop this work further as new members of CCP.

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