

Department for Business, Innovation and Skills: Switching Principles - Call for Evidence

Consultation response from the
Centre for Competition Policy

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for its content.

The Centre for Competition Policy (CCP)

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CCP Response to BIS Switching Principles Consultation

Introduction

CCP welcomes the opportunity to comment on the Department for Business, Innovation and Skills (BIS) proposed 'Switching Principles' for key regulated sectors. Overall we think the principles are reasonable and support the intention behind them of making switching suppliers as easy as possible for consumers. Our comments on the principles themselves are largely points of detail. However, we doubt that the principles themselves will result in a step change in consumer behaviour in the markets being targeted due to the markets' underlying characteristics suggesting that we should expect lower switching rates in them than in other consumer facing markets.

More seriously, we have major concerns about the understanding of consumer switching and the inferences that can be made from headline switching rates displayed in the rest of the consultation document. We have three core concerns. Firstly, observing that consumers are not on the 'cheapest' deal in a market is very different to knowing for certain that individuals are behaving in a non-optimal way¹: we strongly caution against pathologising non-switching as a 'bad' behaviour. The end objective of any policymaker must be to maximise (consumer) welfare rather than switching per se. Switching only leads to increased welfare for a consumer if the gain in welfare from switching supplier (from lower prices or increased quality) exceeds the cost of switching; if this is not the case consumer welfare is reduced by increased switching. The switching rate is best thought of as an intermediate indicator rather than as an end objective.

Secondly, there is no single optimal switching rate; this is particularly true of an established market that has been open to competition for some time. Thirdly, it is important to realise that not all switching costs are amenable to policy interventions, some switching costs may be inherent to the market or the individual being considered. The design of a market and/or the nature of regulation chosen may need to be robust to high switching costs and low consumer engagement, however frustrating/challenging this may be. The switching rate observed is part of the wider market equilibrium and should be understood as such: low switching rates can be completely consistent with fully rational optimising behaviour.

Due to the deeper and more general nature of our comments, we have chosen not to submit our response using the questionnaire provided on the BIS website; instead, our response is structured as follows: firstly, we outline reasons for broadly supporting the switching principles, then we provide an overview of how to think about switching and switching rates, before we provide brief answers to some of questions in the questionnaire and a list of relevant papers on switching by CCP. We also suggest that BIS reviews the applied academic literature on switching and consumer behaviour in the telecoms, banking and energy markets, as Annex C suggests that this evidence may enhance that already gathered.

¹ For example, Ketcham, J., C. Lucarelli, E. Miravete, and M. C. Roebuck (2012), 'Sinking, Swimming, or Learning to Swim in Medicare Part D?', *American Economic Review*, 102 (6), pp. 2639–73 shows that while in the first year following a radical change to US healthcare insurance many individuals appeared to overpay, individuals quickly learnt from this experience: in the second year many consumers switched supplier or reduced the amount by which they overpaid. 'Overpaying' in a new environment may result from rational individuals having incorrect expectations regarding future consumption; through consumer learning these 'errors' may disappear over time.

Broad Support for the Proposed Switching Principles

Switching should be free to the consumer, unless they are aware of and have consented to fair and reasonable restrictions and charges to do so.

The aim that switching should be free *in monetary terms* to the consumer unless they have agreed to restrictions and exit fees etc. is a reasonable one. Any unnecessary cost involved in the switching process, whether monetary or non-monetary, e.g. time involved, is likely to deter some consumers from switching. It should be noted that switching can never be truly “free” in a general sense as any engagement with a market requires time to be devoted by the consumers which could be allocated to other tasks, in other words there will always be an opportunity cost involved.²

More substantively, it is important to allow time restrictions on switching and exit fees as long as a consumer is aware of them and has consented to them, since such conditions may be intrinsic to any ‘deal’. A low unit price may only be profitable for a company if the consumer stays with the firm for a set period of time. Similarly, a company may face costs when a consumer asks to switch and it seems reasonable for a company to be able to recover these costs. Lastly, even in the absence of explicit exit fees the offering of ‘low’³ teaser rates/prices for a fixed time period may only be profitable for firms if the switching rate for consumers at the end of the ‘teaser’ rate is relatively low and a significant proportion of consumers default onto a higher price tariff.⁴ Nevertheless, regulatory authorities should be willing to investigate where contract terms appear punitive and exit fees exceed any reasonable costs even if consumers have consciously consented to these terms.

The switching process itself should be quick, at an agreed date.

A quick and predictable switching process is desirable as both a consumer’s time involved in a switching process and the risk of problems resulting from changes at an unspecified time are potential switching costs which could act as a deterrent to switching. However, we think it is essential to define the notion of ‘quick’ in a clear fashion. There are two very different interpretations: (i) the amount of time a consumer needs to devote to the switching process, and (ii) the calendar time between when a consumer initiates a switch and the point when the service with the new supplier commences.

In general, one would expect that (i) is the more significant deterrent to switching as it involves a clear and direct cost being imposed on consumers.⁵ However, it is noticeable that policy attention has often emphasised (ii). To some extent this is understandable, since consumers will always have to devote some time to searching and switching, although, hopefully initiatives such as ‘midata’ will reduce this time. Similarly, in many markets, particularly those for financial services, it is desirable for firms to ensure a good ‘fit’ between a consumer and the product they are purchasing, such as assessing the ability of a homebuyer to repay a mortgage. To reach reliable conclusions about the quality of ‘fit’ requires firms and consumers to exchange information which will inevitably take time and in many

² Even in the case where a consumer positively enjoys the process of comparing deals there will be an opportunity cost from this activity, in this situation the opportunity cost is the benefit that could be gained from the next most preferred activity if it was performed in the time taken to compare deals.

³ High for savings products in financial services.

⁴ A higher switching rate at the end of teaser period might mean firms withdraw introductory teaser products from the marketplace; whether the demise of ‘teaser’ deals desirable or not probably depends on whether consumers understand the need to evaluate the price of services over the full lifetime of the service.

⁵ We accept that for consumers who highly value immediate gratification reducing the calendar time for a switch to be completed may be important.

cases the amount of information to be exchanged and, therefore, the time involved is heavily influenced by regulatory requirements.

The importance of (ii) is likely to vary across the markets being considered by BIS; having an agreed date to switch may be very important for banking, but significantly less so in energy. In the banking sector knowing when the switch takes place is crucial since people need to co-ordinate payments so that they go to/from the correct account; payment failures impose can impose both time and monetary costs on consumers which could deter switching. In contrast, in the energy sector, regulation ensures continuity of supply so that the co-ordination risks that arise in banking, and which deter switching, are not present.

Also, 'cooling off' periods may present a direct challenge to the completion of a switching process within a short period of calendar time. It is important that provisions regarding cooling off periods are not weakened in any drive to quicken the switching process. Cooling off periods are of direct value to consumers as they enable consumers to correct mistakes, respond to new information and receive protection against firm misbehaviour. Indeed, cooling offer periods may provide the necessary reassurance and confidence required for a consumer to engage with a switching process.

The switching process should be led by the organisation with most interest in making the switching process work effectively – the gaining provider.

As CCP has argued in previous consultation responses⁶, the case for making the gaining provider lead the switching process is a strong one. It is clear that the incentives of the losing provider will almost always be to deter switching⁷ and retain their consumer. More precisely a losing provider led system gives the losing provider an enhanced ability to choose which customers to allow to switch. This may have a serious impact on the performance of rival businesses if the losing provider can choose to target its retention activities at 'valuable' consumers leaving rivals to compete only for less profitable consumers.

It is important to realise that even if the gaining provider leads the switching process at some point the losing provider will be notified of the switch and is likely to have the opportunity to contact the consumer to engage in 'retention activity'. Evidence of this activity in the energy market was present in CCP's analysis of 'The Big Switch' (TBS) collective switching scheme⁸. Of those responding to a survey about TBS, 22.4% of those who switched had received an unsolicited offer from their losing provider. However, this figure is higher than the 7.5% of non-switchers who received a counter-offer from their losing supplier suggesting that in this particular case the retention activity of losing providers may have been self-defeating. In considering retention activity care needs to be taken to distinguish between: (i) making the switching process difficult and complex for the consumer, and (ii) allowing the losing provider to make a 'counter-offer' to retain the consumer. It seems clear that (i) is likely to

⁶ For example, see Deller, D., M. Hviid and A. Kreutzmann-Gallasch (September 2014), response to Ofcom 'Consumer Switching - Next Steps and Call for Inputs' (document attached). The structure of the switching process can also interact with the effectiveness of any price matching guarantees a firm wishes to employ. A review of the literature on price guarantees is provided by Hviid, M. (2010), 'Summary of the Literature on Price Guarantees', a paper for Ofcom available at: <http://competitionpolicy.ac.uk/documents/8158338/8264680/Summary+of+LPG+literature+for+Ofcom+Final.pdf/4f7a0d7b-a3cd-44df-a36d-2d4dc3e13bed>

⁷ An exception to this general rule may occur in banking when a bank may benefit from encouraging a customer with a poor credit profile or high servicing costs to move to another bank. In this case the losing provider can benefit from its superior knowledge of the consumer's characteristics.

⁸ See Deller, D., M. Giulietti, J.Y. J.Y. Jeon, G. Loomes, A. Moniche and C. Waddams (2014), 'Who Switched at 'The Big Switch' and Why?', Report for Which?, the UK's consumer association (document attached)

be detrimental to the consumer and that regulatory bodies should act to stop it; however (ii) involves presenting the consumer with an offer that, after switching costs are considered, may well give the consumer greater expected welfare than the offer of the gaining provider. Indeed, one may consider the ability of a firm to provide a counter-offer as part of a healthy competitive process. Supporting this notion a noticeable minority of TBS survey respondents, 19.8%, contacted their existing supplier after obtaining their offer from TBS to seek a better counter-offer. As a result, regulatory bodies should be very cautious about acting to limit (ii) unless there is evidence of high pressure/misleading sales techniques, and these may be more effectively deterred by applying the relevant consumer protection law.

Consumers should have access to their consumption or transaction data. This should be in a format that can be easily reused (“midata”) and they should be able to authorise third parties such as comparison sites to access their data to help them switch.

CCP broadly supports the principle that consumers should have access to their consumption data in an easy to use format. However, the principle does not explicitly state that this access should be free, despite the potential for a charge to deter consumers from accessing this data. Secondly, we suggest some caution regarding the sharing of ‘transaction’ data. While it seems reasonable that an individual consumer should be able to view their own transaction data, there might be concerns about the routine sharing of transaction data between firms if, for example, this data included price information. Sharing this type of information might facilitate anti-competitive outcomes.

Additionally there are a range of follow-on issues relating to the routine access and use of consumption data which may be important to consider:

- It is proposed that consumers have access to their ‘raw’ consumption and transaction data, what rights will they have to the outputs generated by third parties using their data?
- Increased access to consumption data by firms will almost certainly lead to increased price discrimination across consumers; given the consultation document’s apparent discomfort with price dispersion, is the government comfortable that this is the likely outcome of increased data sharing?
- Given that consumption/transaction data can be used to facilitate price discrimination, will the average consumer be able to make an informed decision about whether or not to reveal this data? Is the non-sharing of data even a feasible possibility, or will market pressures lead to it becoming a standard condition of receiving a service?⁹
- In the energy sector are the data sharing initiatives being proposed/rolled out robust to the dramatic increase in the quantity of data associated with smart meters?
- If extensive data sharing becomes the norm, what are the impacts for regulatory agencies trying to understand firm and consumer behaviour in retail markets? Do the skills, knowledge and resources of regulatory agencies need to be revised?

Sites and tools providing comparisons to consumers that receive payments from suppliers should make clear where this affects the presentation of results.

It seems a laudable aim to increase transparency regarding price comparison websites’ (PCWs’) and other tools’ relationships with the suppliers that they are supposed to be comparing. However, there are likely to be significant issues with making this principle work in practice. Firstly, it is not entirely clear that consumers need information relationships with suppliers as long as it is available to a

⁹ In other words, the non-provision of consumption data by an individual may signal to a firm that the consumer is ‘undesirable’ and so the firm may choose not to supply the consumer.

regulatory body (or another party) that through a robust process, such as a regular mystery shopping exercise, can ensure the rankings provided by comparison tools are correct.¹⁰ This concern is more serious in the set of markets being considered since consumers facing ‘information overload’ has previously been discussed as a concern and providing additional information about commission fees could exacerbate this issue.

Secondly, the statement that comparison tools should “make clear where this (supplier payments) affects the presentation of results” is very broad. It is understandable that a broad principle is desired to recognise that websites may use other features, beyond position in a list, to steer consumers to particular deals such as highlighted boxes and large text etc. However, the phrase “presentation of results” appears to include every possible variable visible on a website including the paid for advertising that is commonly displayed at the top and side of webpages. Additionally, it is unclear how detailed the required explanation by websites/tools needs to be regarding *how* the presentation of results is affected. Is a general blanket warning acceptable? Or do websites/tools have to give precise details of how the presentation of results is affected? The former may be insufficient for a consumer to make an informed decision, while the latter may be so long that a consumer may choose to ignore the description.

In paragraph 4.6 on page 9 the consultation document states that, “the aim of this principle is to increase trust in comparison websites”, whether increased trust will be achieved by increased transparency is not obvious. If some consumers currently believe that comparison websites are ‘independent’, their trust in PCWs may fall when they are informed that sites are being paid for the switches that they generate. An increase in trust seems even more unlikely if comparisons sites disclosures are general and non-specific in nature since consumers will face uncertainty around the extent to which the presented results are being altered.

Additionally, one can question the extent to which it is desirable for consumers to ‘trust’ market participants. In all markets it seems desirable for consumers to have a certain scepticism about the parties they trade with as without this they risk being exploited; frequently consumers are advised that ‘buyer beware’ is a sensible approach to market engagement. The balance which a policymaker may legitimately aim to achieve is for consumers to maintain a critical and alert approach to engaging with particular market participants, while trusting that the overall market and regulatory process is truthful and broadly acts to meet consumer needs.

There should be an effective process for consumers to get redress if anything goes wrong in the switching process.

This is an important principle both to ensure that consumers have confidence that they will be protected from the risk of process errors and to incentivise firms to minimise errors. Our comments relate to what may be defined as an “effective process”. For redress to be effective it must not only be available, but easily accessible with the minimum of consumer effort. Claiming refunds is often perceived by consumers as involving significant ‘hassle’ costs that limit the percentage of harmed consumers claiming redress. One characteristic of the telecoms, banking and energy sectors is that the firms providing the service should know precisely who their customers are and already have their banking details. This means it is plausible that the default position should be one of ‘automatic redress’, i.e. if a firm realises it has made a mistake causing consumer harm the firm will automatically

¹⁰ For additional detail on this point see: Deller, D., M. Hviid and C. Waddams (January 2015), response to the House of Commons Energy and Climate Change Committee 'Energy Price Comparison Websites Inquiry' (document attached)

make a redress payment to the harmed consumers as already occurs with some service failures. Such an arrangement would probably require some degree of regulatory monitoring to ensure that all individuals received the redress payment that they were due. In terms of the technical costs of introducing automatic redress, while these may not be trivial, it should be noted that if the underlying error is easily avoidable then the optimal deterrent is to impose very large penalties on firms for making the error; the costs of implementing an automatic redress system could be consistent with this approach.

It may also be worth treating different types of errors in different ways. If the problems with the switching process are fundamentally random, an effective system of redress seems appropriate. However, if the problems appear more systematic and could be a tool to deliberately manipulate consumer behaviour, regulatory authorities should not be afraid of imposing punitive fines to deter firms from engaging in such activities. Effective consumer redress processes do not represent a comprehensive replacement for regulatory monitoring and enforcement.

A missing seventh principle?

While all of the switching principles seem broadly sensible, there is one omission that might have the greatest chance of significantly increasing the rate of switching in the sectors being considered:

“The switching process should be as easy as is reasonably practical for vulnerable and disadvantaged consumers, in particular for those without ready access to the Internet.”

In Annex C on page 52 refers to the Competition and Market Authority’s (CMA’s) findings in the energy market that those on low incomes and with other indicators of economic disadvantage are most likely to be disengaged and inactive. Similarly, with the heavy emphasis placed on PCWs in many discussions of switching, there remains the question of how those without the Internet can take advantage of the services and the encouragement to switch that these sites provide. While some non-Internet households may access PCWs via friends or relatives acting on their behalf, one cannot assume that all relevant households have these support networks.

Since the vulnerable and those without the Internet face obvious barriers to switching at present, they probably offer some of the greatest potential to raise aggregate switching rates. Despite this, it is notable that in many policy proposals around switching, such as in the CMA’s ‘Notice of possible remedies’¹¹ for its Energy Market Investigation, the policies proposed seem most likely to encourage already engaged consumers to switch more rather than to stimulate a substantial group of the unengaged to become engaged. Indeed, any step change in switching rates is likely to require significant numbers of the unengaged to become engaged. Nevertheless the lack of proposed policies that convincingly target the unengaged probably results from: (i) a lack of knowledge regarding how to encourage the unengaged to become engaged, and (ii) that plausible policies targeting the unengaged are interventionist in nature and potentially involve significant costs. It is the latter point which makes providing an effective alternative to PCWs to those without the Internet a challenging proposition.

¹¹ https://assets.digital.cabinet-office.gov.uk/media/559aac8eed915d1592000023/EMI_Remedies_Notice_-_Final.pdf

Understanding the Meaning of Switching Rates

Why Savings Are Not Equivalent to Lottery Wins:

As noted in the introduction, while we broadly support the proposed switching principles with suitable qualifications, we have significant concerns regarding the underlying implications of switching and switching rates expressed in the consultation document as a whole. This concern begins with the opening lines of the consultation document:

“If you knew you had won £200 on the lottery, would you forget to claim it? Probably not. Yet consumers across the UK are effectively ignoring significant savings every year when they stick with their current providers of essential but routine services.”

Such a statement misrepresents the problem facing consumers on two levels. Firstly, consumers routinely ignore monetary discounts outside the sectors being considered when they omit to use money off coupons in supermarkets etc. Furthermore for a consumer to win £200 on a lottery a consumer must already have purchased a lottery ticket. That the individual has already made this purchase means that they have shown active engagement and interest in the ‘lottery market’. Many of those who apparently ignore savings in, for example, the energy market have not expressed the same positive engagement with the market, rather they have to purchase energy and use the minimum possible engagement to achieve this end.

Secondly, and more seriously, the value to a consumer of £200 in cash, i.e. the lottery win, and a quoted £200 saving on a routine service are not equivalent. For example, suppose an individual is told they can save £200 on their energy supply, the actual welfare gain which they receive from switching may be substantially lower. Firstly, they need to check if there is an exit fee from their existing deal which could reduce their gain. Then there is the non-monetary cost they face in going through the switching process. Thirdly, while a switch may save a consumer £200 they may need to trade this monetary saving off against differences in the non-price aspects of the service they receive, such as the quality of customer care and customer communications. Differentiation in service and content is likely to be particularly important in the banking and telecoms sectors respectively. Fourthly, the £200 saving is a predicted saving, it is not certain like a lottery win, energy bills can vary away from estimates both because prices change and the quantity consumed may increase, such as when there is a particularly hard winter. Lastly, as the saving is a prediction and is not legally binding, not only is there genuine uncertainty about the saving size, but also a consumer may, rightly or wrongly, question the credibility of the saving figure when quoted by a party with a vested interest in the consumer’s switching decision.

While we are sympathetic to the notion that many consumers are currently receiving a bad deal, for many individuals the headline savings quoted may prove illusory. Indeed, the uncertainty around whether quoted savings will actually materialise is a key issue that can deter consumers from engaging with the energy market. When designing policy interventions these nuances must be recognised and understood if good outcomes are to result.

An Optimal Switching Rate Does Not Exist:

Similarly, we are concerned by the following sentence in paragraph 2.1:

“The aim of this is to reduce the frictions in the switching process, in particular in those regulated sectors where consumer engagement has been lower than might be expected and where some consumers currently miss out on savings.”

The first concern relates to the statement that “consumer engagement has been lower than might be expected”, this seems to imply that switching in the markets being considered is unnaturally low. What evidence is there to make this judgement? Even if switching rates in the energy and banking markets are well below those observed in other markets, this is insufficient evidence to demonstrate that the switching rates in the energy and banking markets are ‘abnormally’ low. The correct way to view the switching rate is as part of the equilibrium that results from the market process. While we may hope to see a high switching rate, due to the intuition that engaged consumers will keep firms on their toes, the switching rate itself is a market outcome. A low switching rate may be an inherent characteristic of the markets being discussed with high switching costs being an obvious reason for this outcome.

The statement in paragraph 2.1 also prompts one to ask what was the expected ‘satisfactory’ switching rate? Why was this rate of switching more desirable than any other level of switching? From a theoretical perspective there is no optimal switching rate. In a world where all consumers are on the deal offering them the highest utility (not necessarily the lowest price) the optimal switching rate is 0%, while in a world where no consumers are on the deal offering them the highest utility the optimal switching rate is 100% (assuming zero switching costs).¹²

This logic implies that a high switching rate could even tell a negative story, indicating that consumers are very poorly matched with their existing providers and are seeking something better. To suggest that a high switching rate is beneficial it is first necessary to believe that consumers are poorly matched with their existing suppliers. This assumption is probably correct at the point of retail market opening, when it seems reasonable to assume that for many consumers the first opportunity to exercise choice, and move away from their incumbent supplier will be beneficial. Hence, for the first 3-5 years after market opening, the notion that ‘more switching is better’ seems reasonable; however, after this initial activity, once a mature market has developed, it becomes much less clear what is the ‘desirable’ level of switching. In a mature market, and once barriers to switching amenable to policy interventions have been removed, the resulting level of switching may simply have to be accepted as a characteristic of the market being considered. In such a situation policymakers need to design interventions which are robust to the low level of switching observed, rather than pursuing consumer engagement for its own sake.

What Non-Switching Indicates is Inherently Unclear:

The second concern with paragraph 2.1 is the apparent certainty in stating “some consumers currently miss out on savings”. While on a practical level we are sympathetic to the view that many consumers are missing out on good deals, from a rigorous academic perspective we cannot *know* this is true. It would be more appropriate to state that “some consumers *might* currently miss out on savings”. Realistically, all we can hope to do is to find evidence which is suggestive of individuals leaving money on the table. At the heart of the problem is the ‘observational equivalence’ of several outcomes, namely the observation of a person not switching could indicate one of (at least) four different things:

1. Consumers are happy with their existing supplier(s) and would not want to switch even if switching costs were zero
2. Consumers would switch suppliers if switching costs were low enough, but switching costs are too high for consumers to be better off through switching
3. Consumers are misinformed about their ability to switch, the size of savings available or about the size of switching costs

¹² Of course, in the period following 100% switching, the optimal switching rate would be 0%, assuming everything in the world remained constant and consumers did not make errors.

4. Consumers are inherently disinterested or 'irrationally' ignore opportunities for savings. Of course, in any given market there are likely to be some consumers falling into each of these four groups. The question for policymakers, and one which is very challenging, is to determine in which group the majority of consumers lie.

High Switching Costs and Low Switching Rates May be Inevitable:

Given that the observed switching rate is a market outcome, we caution against unrealistic expectations that adopting the proposed switching principles will result in a step change in consumer behaviour. We suspect that while positive, their impact will be 'at the margin' rather than transformational. This is particularly the case given that the table on page 10 of the consultation document reveals that many of the switching principles are already in place. It is likely that the principles will make consumers who are already 'engaged' more likely to switch and may improve the quality of their switching¹³ rather than stimulate substantial numbers of the unengaged to become engaged and consider switching.

If there are large inherent switching costs in telecoms, banking and energy markets, policy action will not be able to overcome these. We fully support media campaigns (assuming that they can be delivered at reasonable cost) which provide information that emphasises the benefits and ease of switching, thus tackling situation 3 above. However, we believe that the markets being considered have intrinsic characteristics that mean we might expect lower rates of switching than in other consumer-facing markets. We caution against policymakers overemphasising the importance of increasing switching rates in making markets work well (this a different message to telling individual consumers that there may be benefits to switching), since there may be fundamental difficulties in using policy levers to raise switching rates by a substantial amount. By trumpeting measures to increase switching rates there is the risk of creating 'a rod for one's own back' should substantial increases in switching rates fail to materialise. The resulting political pressure surrounding an apparent policy 'failure' may then lead to policymakers to introduce further piecemeal interventions which may be inconsistent and potentially harmful to the functioning of the market.

Paragraph 3.4 on page 6 of the consultation document states:

"Consumers are often willing to engage if the choices are clear and easy to make, the reward/pay back immediate or obvious, or the subject interesting to the buyer. Consumers make active choices when it comes to supermarket shopping for instance, with customers often going to different shops for different items or choosing between competing brands within a store."

First we question how strong the evidence is that in the supermarket setting there are high switching rates between brands and superstores? Is the switching rate between Coke and Pepsi really so high? Similarly, how many people switch between using the out-of-town superstores of Sainsburys and Tesco in any particular year?¹⁴ As in the energy market, a reasonable starting presumption would be to expect that there is a group of highly engaged and price sensitive shoppers and another group who

¹³ A high quality switch is one to the product offering the greatest expected benefits, often the largest savings, and avoid deals that would actually make them worse off. Additional detail on the quality of switching in the UK energy market can be found in: Waddams Price, C. and C.M. Wilson (2010), 'Do Consumers Switch to the Best Supplier?', Oxford Economic Papers, 62, pp. 647-668.

¹⁴ Note that a distinct switch from shopping at Sainsburys to Tesco is rather different to a consumer pursuing a 'multi-homing' strategy where a consumer regularly shops at both Sainsburys and Tesco, purchasing different products in each store.

find food shopping a chore and simply want to minimise the time in any particular shop or who find the travel costs involved in switching between supermarkets prohibitive.

There are good reasons to suspect that, for a substantial proportion of people, the choices in the services markets being considered are inherently not that clear and easy, involve uncertain pay-offs that occur after a considerable period of time and will always be 'dull'. Here a comparison to understand the differences with the supermarket example may be instructive.

Consider a supermarket staple such as bread: in a large supermarket there might be 100 different breads arranged in an aisle. Yet we can quickly narrow the choice down to perhaps no more than three options that most closely match our preferences by looking at the size, colour, shape, brand and packaging of the different breads. We may then look in detail at the prices and use by dates of the three most preferred options before making a final decision. Now suppose that instead of all the different breads being displayed on shelves we are faced with only a sheet with the 100 price labels that were attached to the shelves of the bread aisle. These labels might state the price, a brief product description including brand, weight and price per gram. The choice problem of selecting the most suitable bread now seems inherently more difficult and challenging as we cannot use our visual senses to evaluate different aspects of the breads, to which we attach differing importance as idiosyncratic individuals. Instead, to make a fully informed choice we would have to study each of the labels closely which seems a rather laborious task. As any competent business is likely to realise that displaying the products themselves helps consumers' make their choices and is likely to increase sales, competition between stores naturally leads to the beneficial outcome of supermarkets displaying all their products on aisles.

The 'invisible' nature of energy, banking and telecoms¹⁵ services inherently requires the use of written information to compare products as opposed to the wider range of senses that we can deploy in the bread aisle example. Also, if we added additional written information about the products' non-price characteristics this may make the comparison task even more laborious as there is more information to wade through. That competition in energy, banking and telecoms has been present for a considerable period of time, and that a better solution to displaying various forms of written information has not emerged suggests that this issue is one which is embedded in these markets and is not easily amenable to policy intervention. Of course, the markets have experienced one substantial innovation to ease comparison: PCWs. Such tools help to narrow the choice problem we face to one analogous to comparing a limited number of breads before making a final decision in the supermarket example. However, reliance on these tools raises new issues as noted in the consultation document such as:

- How do we know that the results being displayed are accurate?
- Do the tools allow us to search according to our own idiosyncratic tastes?
- Are we more susceptible to words like 'Special Offer' and other visual cues, when tangible products are absent?
- How do we assess quality when we cannot touch or 'play' with a product?
- What if the comparison between the 'narrowed' set of recommended services is still a complex one?

These points indicate that while price comparison websites are very valuable they cannot convert the service markets being considered into the supermarket aisle example. It is likely that, on average, even after using a PCW, a consumer will find choices in the sectors being considered more challenging than those in a supermarket and so we would expect a lower switching rate to be observed in these sectors.

¹⁵ Assuming we are not making a choice about a particular mobile phone.

While policy interventions may be able to reduce the severity of the issues in the five bullet points above it is unlikely that they can be fully overcome.

Similarly, it seems difficult to think how the issues of uncertainty and lengthy time periods before benefits are realised can be changed unless the energy, telecoms and retail banking markets are substantially redesigned. Even in the unlikely event that markets were redesigned, uncertainty regarding consumption, such as due to weather conditions in the energy case, would remain. Lastly, it seems likely that the service markets considered are inherently duller to the average consumer than shopping for clothes or gadgets where many people consider the interaction with different products to be an inherently enjoyable experience.

Policymakers May Need to Accept 'Imperfect' Market Outcomes:

For the reasons outlined above a realistic policymaker has to seriously consider the possibility that low switching rates are likely to persist in the markets being considered. Beyond taking actions to reduce unnecessary switching costs and improving consumer knowledge, policymakers may have to accept that the outcomes of actual markets are imperfect and are unlikely to deliver all of the benefits of their idealised visions. In this interpretation the statement on page 40 that "(a) lack of consumer switching has a detrimental effect on competition" is not necessarily correct. It is a lack of consumers with 'active' or 'engaged' preferences/behaviour that is detrimental for effective competition, a low switching rate is part of the equilibrium market outcome and so is likely to be a symptom, rather than the cause, of a poorly performing market.

A particular case in point regarding realistic expectations of markets is the issue of price dispersion and the notion that some consumers are getting 'better' deals than others. The confusion and the tensions surrounding this issue are apparent in paragraphs 3.5 and 3.6 of the consultation document. In paragraph 3.5 it states "we don't enjoy being called on to make frequent decisions about everyday items which aren't clearly differentiated as to price or quality", while in paragraph 3.6 it states "there are still a significant number of consumers who do not engage or if they do, do not always get the best deal." The point in paragraph 3.5 is that to motivate switching there must be different deals available with different prices to provide the necessary financial incentive for consumers to engage in the effort of switching. CCP has consistently found strong evidence that monetary savings are a central driver of switching.¹⁶ The quotation from paragraph 3.6 emphasises dissatisfaction with the fact that not all people are on the 'best' deal for them. Yet it is not possible for everyone to be on the same 'best' deal¹⁷ and for there still to be sufficient price dispersion in the market to motivate further switching. Indeed, in this 'perfect' scenario not only would we expect to see a limited range of offers in the market, the switching rate would be zero until the environment changed or new, better, offers emerged. A high switching rate is only likely in a market where there is price dispersion and consumers are spread across different deals which implies that some consumers will be getting better deals than others.

¹⁶ See: Giulietti, M., C. Waddams Price and M. Waterson (2005), 'Consumer Choice and Industrial Policy: a study of UK Energy Markets', *The Economic Journal*, 115(506), pp 949–968; C. Waddams Price and M. Zhu (forthcoming January 2016), 'Empirical Evidence of Consumer Response in Regulated Markets', *Journal of Competition Law and Economics*; and Flores, M. and Waddams Price, C. (2013), 'Consumer Behaviour in the British Retail Electricity Market', CCP Working Paper 13-10 (document attached).

¹⁷ We define the 'best' deal as the cheapest deal amongst the set of products/services which have the same/similar non-price characteristics.

The point of the above discussion is to highlight that soon we may reach a point where the plausible methods to raise switching rates in essential service markets have been exhausted and policymakers will be faced with the following choice:

- (i) Accept the outcomes delivered by the market – the market is good at achieving efficiency and active consumers will receive good deals, but the market is poor at achieving distributional objectives. Price dispersion is a natural part of the market process and inactive consumers are likely to pay considerably more than active consumers.
- (ii) Reject market outcomes and adopt some form of price regulation – regulation will limit price differentials between consumers, but incentives for efficiency and innovation are unlikely to be maximised and the complexity of price regulation will have to be managed.

We are not trying to advocate one or other of these positions, but simply want to highlight that continual policy interventions in a liberalised market, but which are short of full price regulation, may fail to deliver substantial positive changes to the markets being targeted, and may be detrimental. Policymakers may need to accept that, given consumers' actual rather than desired or hypothesised behaviour, there is no free lunch where all consumers are automatically on the best deal for them.

While the above argument may seem rather 'negative', it is not designed to detract from the broad value of the switching principles outlined in the consultation document. As long as these principles can be achieved at reasonable cost we broadly support them; however, we want to suggest that their impact is likely to be limited and that we need to accept consumers 'as they are' rather than 'as we wish them to be'¹⁸ when designing policy.

Searching vs Switching:

The final major point we wish to make regarding the consultation document is that the discussion is all about 'switching', there does not appear to be a detailed exploration of whether or not individuals engage in 'search' before switching. Noting this distinction is important when interpreting market statistics and consumer behaviour. Firstly, consumers may engage in lengthy search processes but then choose not to switch as the search confirms that the consumer is on the best deal available or that the savings available are insufficient relative to the costs of switching. This shows that consumers may be highly engaged with a market and fully understand what is available, but rationally still may not switch. Notably this type of engagement will be missed if one purely looks at switching rates to understand 'consumer engagement'.

Secondly, it is possible that consumers may switch without conducting any substantive search before making the switch. This scenario would occur if a consumer receives some form of direct marketing (e.g. letter, email or phone call) and makes a switch purely on the basis of the saving being quoted. Assuming that mis-selling is not occurring, such a switch should make a consumer better off, however, as a full market search has not been conducted, the new deal that the consumer accepts may not be the best deal on the market.

¹⁸ As an example of assuming the latter, in the consultation document on page 49 is a list of information that consumers are supposed to need to make fully informed and rational decisions in the energy, telecoms and current account markets. It is questionable how many consumers actually gather all the described data together and perform the necessary calculations implied to make a fully optimal decision. If consumers perform calculations, they are likely to perform them subject to constraints, such as limited time or limited knowledge of different deals. Other consumers may simply rely on imprecise decision 'heuristics'. Once again we wish to distinguish between the valuable policy of making the information displayed on page 49 more accessible and the questionable assumption of believing consumers fully utilise this information in the correct manner when making switching decisions.

It may also be helpful to separate the concept of search costs and switching costs. We can think of search costs as being those involved in obtaining and understanding the different deals available in the marketplace. Switching costs can then be defined more specifically as those costs associated with the actual process of switching once a consumer has identified the preferred service for their needs. To obtain the best deal in the market a consumer is likely to have to incur both search and switching costs, and these costs may vary across different types of consumers and across different markets. Heterogeneity across markets, consumer types and individuals is very clear from CCP research¹⁹.

Responses to Specific Questions

General Points Regarding the Consultation Questionnaires/Other Surveys:

Below we provide brief responses to the questions given in the questionnaire entitled 'Respondents Other Than Consumers'. Before responding to these questions we note that the questionnaires in the consultation document for switching and non-switching consumers appear to be constructed as if they were a 'mini-survey'. While we support the opportunity for consumers to respond to this consultation, we want to give a strong caution regarding the presentation and interpretation of the results obtained from these questionnaires since they will not be representative of the population as a whole. Firstly, as the consultation is being made available through the BIS website it is likely that very few individuals without or with limited access to the Internet will be able to respond. This is particularly important given the fact that those without internet access are much less likely to switch, for example, the CMA's Energy Market Investigation consumer survey found that while 29% of respondents with internet access had switched supplier in the prior three years only 11% of those without the internet access had switched in the same time period.²⁰ Secondly, the respondents to the questionnaires are likely to be unusually motivated to respond to calls to action relative to average members of the population. For these reasons we would expect the consultation responses to be disproportionately skewed towards 'active/engaged' individuals. This means that while the responses can provide useful 'case studies' of the barriers that people may face when switching, statistics such as the 'percentage reporting switching difficulties' should not be used as part of the evidence base to take a decision on whether or not to implement the proposed switching principles.

This note of caution regarding the evidence to support the switching principles is all the more relevant given that representative surveys conducted by sector regulators, academics and other bodies are available and can provide higher quality evidence. Our one note of caution with using this wider survey evidence is that the sampling frame for each of the surveys needs to be understood. For example, on page 7 of the consultation document figures are provided for multiple sectors based on Ofcom's 'Switching Tracker'. An important question to check is whether the sample for this survey was designed to be representative of the whole population or only representative of telecoms bill payers? If it is the latter, one might be concerned about the switching rates quoted for the energy and banking sectors. To maximise evidence from surveys, it may be instructive to take all the switching rates calculated from different surveys and provide a range of values rather than a single figure.

Answers to Specific Questions:

Q1 Yes, switching costs and contract terms can deter switching. See above for details.

¹⁹ See Waddams Price and Zhu (forthcoming 2016).

²⁰ See paragraph 87(a) on page A8.1-26 of 'Appendix 8.1: CMA domestic customer survey results', an appendix to the CMA's 'Energy market investigation – Provisional findings report' available at: https://assets.digital.cabinet-office.gov.uk/media/559fb619ed915d1592000044/Appendix_8.1_Customer_survey.pdf

Q3 The question talks about “free switching”; as discussed above it is much easier to consider switching which is *free in monetary terms* than free in terms of the opportunity cost of time that consumers have to devote to switching. On the latter point it may be difficult to do more than minimise the time that a consumer has to devote to the switching process.

Q4 As discussed above, it is crucial to define what is meant by “length of time”, does it refer to the calendar time required for a switch to complete or the actual amount of time a consumer has to dedicate to completing a switching process? In general, we would expect the latter to be a much greater deterrent to consumer switching since it implies a direct cost to a consumer.

Q7 This question makes most sense if one believes that when a consumer engages with the ‘losing provider’ they are given messages that will deter them from switching. The quantity of time that a consumer has to engage with *any* provider is likely to be a more significant deterrent to switching than the identity of the provider that they have to engage with. Also, as we discuss above, if the aim of a policy is to maximise consumer welfare rather than the switching rate, we caution against a block on the losing provider being able to provide a consumer with a ‘counter-offer’.

Q10 In general, it seems relatively difficult for consumers to compare usage in the markets considered in a way that allows fully informed and rational decisions regarding whether to switch or not. While it is desirable for information to be provided in as simple and clear a format as possible, there are two factors that might mitigate concerns in this area. Firstly, we suspect there are no markets where the majority of consumers sit down and precisely calculate different potential savings in the manner of an idealised fully rational optimising individual. Secondly, it may not be necessary for an individual consumer to have a detailed understanding of their usage and its implications, if the required information is in a readily accessible form for it to be inputted into PCWs/other tools to perform the necessary calculations on the consumer’s behalf.

Q11 Again it is not totally clear that consumers need “to better understand their usage patterns”, if there are tools/PCWs available to make the necessary comparisons on a consumer’s behalf. In energy, moves to smart meters have the potential to provide such detailed consumption data that it is impossible for a human to compare the cost of different product offerings by hand. If consumption is recorded at half-hourly intervals, it would result in 17,520 consumption data points per annum.

Q12 This question may be too broad. Firstly, it is likely that engaged and unengaged consumers may have noticeably different confidence in PCWs. Those who actively use PCWs at present are likely to have confidence regarding what the PCWs can and cannot do, otherwise they would not use them. Regarding those consumers who do not use PCWs it is probably more difficult to identify the precise factors that would lead them to have confidence in PCWs. Secondly, the great variety of PCWs needs to be understood. We have been led to believe that there are up to 200 PCWs in the energy market alone, but only 12 are actually accredited by Ofgem.²¹ Lastly, is “comparison sites will give them a *good chance* of identifying the best deal for them” a sufficiently ambitious policy objective? Are consumers likely to want to engage with sites that only have a “good chance” of identifying the best deal for them? If sites only have a “good chance” of identifying the best deal, should policymakers be promoting their use or warning consumers about their inaccuracy? It may be beneficial to distinguish between the best deal in monetary terms and the best deal in non-monetary terms. A sensible starting point should be that a PCW should always identify the cheapest deal amongst those within the

²¹ The current confidence code means that only PCWs who have their own database of tariffs can be accredited. Other sites that ‘rebadge’ the services of accredited websites cannot be accredited themselves, as a result GoCompare is not an accredited site despite using the underlying technology/data of a PCW which is accredited by Ofgem.

category of products a consumer chooses to compare and if a PCW does not compare all the tariffs on the market, this should be clear to the consumer.

Q13 It seems likely that consumers will have greater confidence in PCWs if they can be assured that the PCW they are using compares all of the deals on the market.

Q16 As discussed above, since firms in the energy, telecoms and banking markets are likely to possess consumers' contact and bank account details it would seem plausible to require an automatic redress system where firms provide compensation to all the consumers they can identify as suffering harm. Such a system would lead to the maximum number of consumers receiving redress and the maximum incentive for firms to avoid errors.

Q18 Below we provide a list of academic papers and consultation responses produced by CCP which are directly related to the topic of consumer switching. If required, we are happy to discuss these works in further detail with BIS.

Further CCP Work on Switching:

Published Academic Articles:

Giulietti, M., C. Waddams Price and M. Waterson (2005), 'Consumer Choice and Industrial Policy: a study of UK Energy Markets', *The Economic Journal*, 115(506), pp. 949–968

Garrod, L., M. Hviid, G. Loomes and C. Waddams Price (2009), 'Competition Remedies in Consumer Markets', *Loyola Consumer Law Review*, 21(4), pp. 439-495

Waddams Price, C. and C.M. Wilson (2010), 'Do Consumers Switch to the Best Supplier?', *Oxford Economic Papers*, 62, pp. 647-668

Hviid, M. and C. Waddams Price (2014), 'Well-functioning markets in retail energy', *European Competition Journal*, 10(1), pp. 167-179

C. Waddams Price and M. Zhu (forthcoming January 2016), 'Empirical Evidence of Consumer Response in Regulated Markets', *Journal of Competition Law and Economics*

Books, Reports and Working Papers:

Garrod, L., M. Hviid, G. Loomes and C. Waddams Price (April 2008), 'Assessing the Effectiveness of Potential Remedies in Consumer Markets', a report for the Office of Fair Trading, OFT994

'Behavioural Economics in Competition and Consumer Policy' (2013), ESRC Centre for Competition book, editor J. Mehta

Flores, M. and Waddams Price, C. (2013), 'Consumer Behaviour in the British Retail Electricity Market', CCP Working Paper 13-10

Deller, D., M. Giulietti, J.Y. J.Y. Jeon, G. Loomes, A. Moniche and C. Waddams (2014), 'Who Switched at 'The Big Switch' and Why?', Report for Which?, the UK's consumer association

Consultation Responses:

Ball, C., M. Hviid, G. Loomes and C. Waddams (June 2011), response to Ofgem, 'The Retail Market Review - Findings and Initial Proposals (RMR)'

Morten H., G. Loomes and C. Waddams (2012), response to Ofgem, 'The Retail Market Review: Domestic Proposals'

Deller, D., M. Hviid, J.Y. Jeon, D. Mantzari, C. Waddams and M. Zhu (April 2014), response to Ofgem, 'Protecting consumers in collective switching schemes'

Hviid, M. , D. Mantzari and C. Waddams (May 2014), response to Ofgem, 'Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain'

Deller, D., M. Hviid and A. Kreuzmann-Gallasch (September 2014), response to Ofcom, 'Consumer Switching - Next Steps and Call for Inputs'

Waddams, C. and M. Zhu (November 2014) response to the Competition and Markets Authority, 'Retail Banking Market Investigation - Statement of Issues'

Deller, D., M. Hviid and C. Waddams (January 2015), response to the House of Commons Energy and Climate Change Committee, 'Energy Price Comparison Websites Inquiry'

Waddams, C., M. Hviid and David Deller (August 2015), response to the Competition and Markets Authority, 'Energy Market Investigation - Notice of Possible Remedies'