

Assessing whether competition is effective in retail markets: lessons from energy and banking

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My background

- Energy expert, banking novice
- 10 years at regulator Ofgem in a variety of roles: Managing Director, Markets then Networks
- Strong advocate of use of competition and sectoral powers where appropriate
- Some notable personal successes (Gas metering) and failures (Market Abuse Licence Condition)
- Regulators can and should make interventions to improve competition and consumer outcomes
 - Wholesale energy market reforms
 - Ombudsman and back billing in response to consumer complaints in retail energy markets

Recent developments (pre dating my change of role) have caused me to question whether regulators have lost sight of why, when and how to intervene...

The thesis/questions/concerns

1. Do we have realistic expectations and/or even know what a competitive retail market looks like?
2. Has the economics caught up with the implications of new technology (primarily internet) – and are markets still learning/adapting?
3. Are we sanguine enough about unintended consequences when considering interventions in markets?
4. Fairness is best left to the politicians and is a dangerous minefield for independent, unelected regulators

The standard approach fails to understand the competitive process...

“Market studies involve an analysis of a particular market, or practices across a range of goods and services, ***with the aim of identifying and addressing any aspects of market failure*** from competition issues to consumer detriment and the effect of government regulations” – **OFT website**

If the partial genius of market economies lies in their capacity to achieve co-ordination without a co-ordinator, the greater genius lies in their ability to innovate and adapt in an environment of uncertainty and change. The sustained achievement of market economies comes from their pace of innovation—in products, technology and organisation—derived from the ability of market systems to undertake small-scale experiment, to watch the results, to mimic what works and discard what doesn't – **“The Failure of Market Failure”** John Kay, Prospect Magazine 2007

What does a competitive retail market look like?

What does a competitive retail market look like (II)?

- Better defined by what it isn't?
- Not perfect competition (or anything like it)
- If greater genius of markets is innovation then worry less about static inefficiencies – markets make mistakes, learn and adapt over time
- No simple measures or shortcuts – no simple single metric such as switching levels, number of providers, profitability
- Need to look at a broader range of indicators holistically, over a realistic timeframe and relationships between them
 - Switching, market shares, patterns of entry and exit, innovation
- Innovation perhaps the most important but be realistic and in the relevant context (computers and mobile phones vs energy)

Has economics caught up with technology development?

- Maintaining multiple prices and products used to be relatively expensive because of menu costs
- Rise of internet and IT systems has significantly reduced cost of maintaining multiple legacy tariffs for homogenous products/services
- Effects are seen in many retail markets from firms with no market power by conventional metrics
 - 1,000,000 mobile phone tariffs
 - British Gas Websaver 1,2,3,4,5,6,7,8,9,10, Click energy 1,2,3,4,5,6
 - Selective discounting in supermarkets – customer specific vouchers printed at tills
- Can we effectively distinguish between undue price discrimination and these new forms of product/customer segmentation?
- Dilbert Economics – beware the “Confusopoly” not the “Monopoly”
- Should regulators be concerned?
 - Promote transparency and easy switching: but
 - Some (all?) markets still relatively immature and adapting/learning
 - Markets best placed to “solve” if customers consider a problem – e.g. “Everyday Pricing”, “Never knowingly undersold” etc

Unintended consequences of intervention?

1. Some potential examples:
 - **Energy retail** – did banning undue price discrimination raise average prices?
 - **Business banking** – did price controls stifle innovation?
2. Does price/product intervention reduce entry?

Fairness?

- Fairness is a difficult and dangerous concept for unelected regulators
- Is it unfair that customers who switch and are active in the market get a better deal than customers who stay with their supplier?
 - Search has costs (even in the internet age) gains from search necessary to drive competition
 - Removing gains or levelling prices undermines incentive to search and reduces competitive pressure
- Well developed retail markets can and do find mechanisms to reward loyalty
- Regulator cannot and should not assume knows the mind of customer – and how they value brand, service and value of their time

Some lessons...

- **Competition is a process** – starting point should not be an assessment against an unrealistic or static benchmark
- **Market failure** is not a useful or sufficient condition for intervention
- **Best interventions** likely to be those that work with the competitive process not seek to subvert it
 - Removing/reducing barriers to entry;
 - Promoting greater transparency and making services/products easy and simple to compare;
 - Removing barriers to switching providers;
- **Interfering** with product pricing, design (almost?) never a good idea

Competition in energy markets: Ofgem's views

- **Retail Probe 2008**
 - Competition not yet **fully effective** not all customers are reaping the full benefits of competition
 - Measures to improve the functioning of the market
 - Prohibition on undue price discrimination
 - Package of marketing and information remedies (annual statements)
- **November 2010** : Investigation into profit margins of energy suppliers
 - Margins risen from £65 to £90 after recent price rises

Competition in banking markets: Past and recent history

- Long history of regulatory investigation and concern going back to Cruickshank review in 2000
- Competition Commission on business banking and price controls
- More recent OFT investigations and interventions in Current Accounts and Cash ISAs and barriers to entry
- Independent Commission on Banking looking at competition and financial stability
- More recent FSA consultations and proposals:
 - Mortgage Market Review: LTV caps? Banning products to certain types of consumer – self employed, interest only mortgages
 - Product Intervention: anticipate consumer detriment and stop it before it occurs - product pre-approval, banning products, pricing interventions

Competition in banking markets: The regulators' views

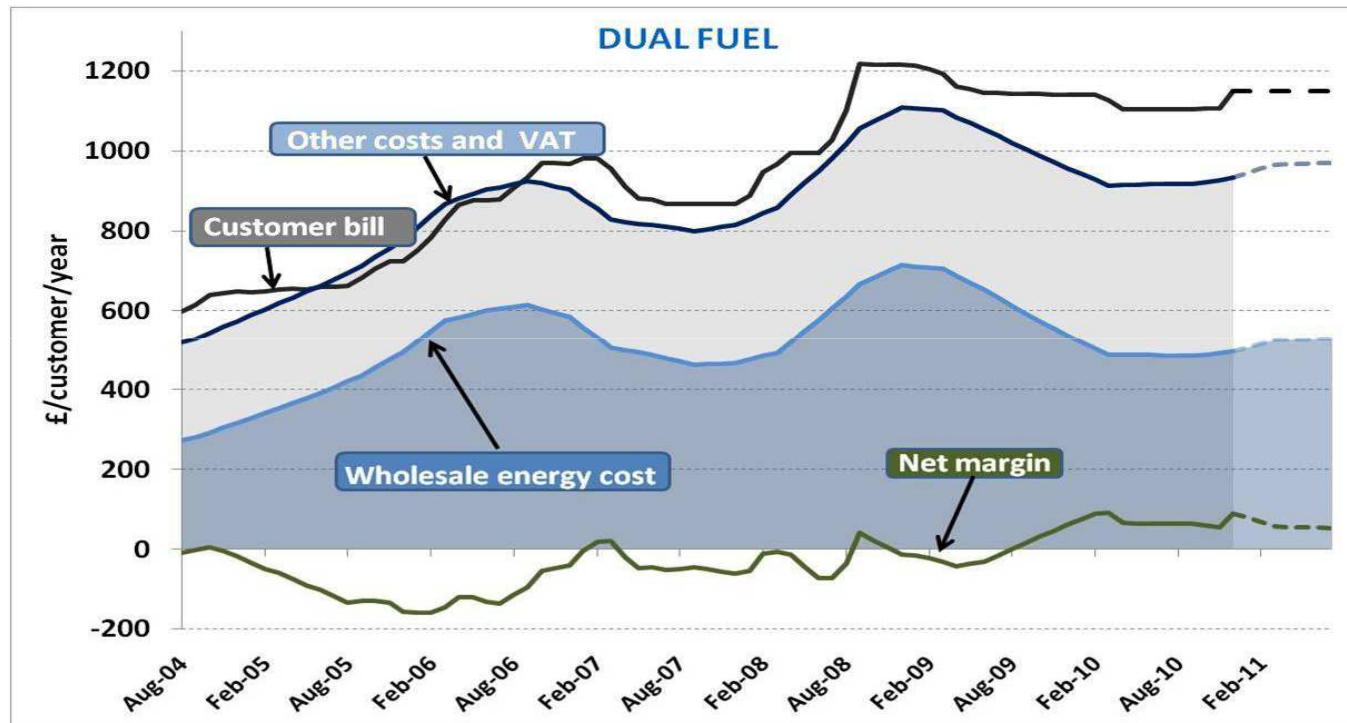
- Concentration increased significantly during financial crisis and is high relative to other countries' banking markets
- Market shares of big providers relatively stable over many years
- Barriers to entry are relatively high (branches, brands, "free in credit" banking)
- Limited/no new entry since second world war
- Particular concerns in current accounts and seen as "gateway product" reinforcing position of incumbents
- Poor consumer outcomes: lack of transparency, mis-selling
- Fairness of fee structures: overdraft fees

Energy through a different lens?

- Level of switching is high relative to expectations when markets first liberalised
- 6 suppliers is a reasonable starting point – relatively large number compared with many markets
- Lack of entry has been a concern but some encouraging signs (finally) of new entry: First Utility, OVO, Basic Power, EBICO
- Evidence of innovation: dual fuel, internet only tariffs, monthly bills based on self read and smart metering
- Some positive regulatory interventions: annual statements, tighter marketing rules
- Some recent regulatory interventions may be harming customers and competition
- Concerns expressed about price discrimination clause by George Yarrow, Catherine Waddams, Stephen Littlechild and...
- “the proposals are likely to be detrimental to consumers and therefore bad policy. Banning price discrimination stops important kinds of price competition – for example, regional incumbents challenging one another – and so perversely can blunt competition and **help firms sustain higher prices to consumers in general.**” **Sir John Vickers**

Energy through a different lens?

Stylised retail margins on a dual fuel customer



1. Would you see this as an attractive market to enter?
2. What was the most significant change in the period when margins increased prompting Ofgem's recent concerns?

Banking through a different lens?

- Concentration isn't high relative to other retail markets or other countries' banking markets
- Market is contestable: barriers to entry low in all but current accounts
- Successful new entry and expansion in card, loans, savings, mortgages and current accounts
- Current accounts not gateway product
- Branch access, "free in credit" banking, brands not barriers to entry
- Metro Bank, Tesco and Virgin have/will enter current account markets
- Good track record on innovation and technology likely to remove any remaining barriers to entry

Some lessons for regulators...

Regulators should focus on:

- Barriers to entry (but be realistic)
- Transparency
- Switching processes

But should exercise caution before wading in on:

- Fairness
- Price intervention
- Structure

Some implications for energy?...

- Switching processes are effective
- Transparency is still an issue: smart metering, annual statements should help
- Barriers to entry and impact of government policy (EEC, ROC, CERT, CESP) not sufficiently investigated?
- Fairness is not a good reason for regulatory intervention and decreases welfare?
- Can Ofgem objectively review retail market given price discrimination condition may be a cause of some of the problems?

Some implications for banking?...

- Starting position is relatively good
 - Significant number of providers (10-80 in 5 markets)
 - Technology (internet and mobile) reducing barriers to entry (branch)
 - Credible new entry and expansion
- Switching in current accounts is a problem
- Transparency in current accounts and savings are problems
- Direction of travel of FSA and CMPA very worrying – product and price intervention ex ante

Some propositions to debate!

1. Primary goal of regulators should be to establish conditions for competition to flourish: Transparency, switching, reducing any barriers to entry (are brands a barrier to entry?)
2. Market failure is not a particularly useful or productive framework for regulators
3. Pricing and product intervention is (nearly) always a bad idea
4. Current implied benchmarks of what a competitive market looks like needs urgent reappraisal (definition?) – and need to think through the economics of new technology
5. Markets take time to solve problems and learn from mistakes/failures: regulators need to be measured and not intervene/investigate too quickly
6. Fairness is for politicians not regulators