CENTRE FOR COMPETITION POLICY

Role of Consumers in Regulation: from passive recipients to necessary actors

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Competition, Regulation and the Role of Consumers

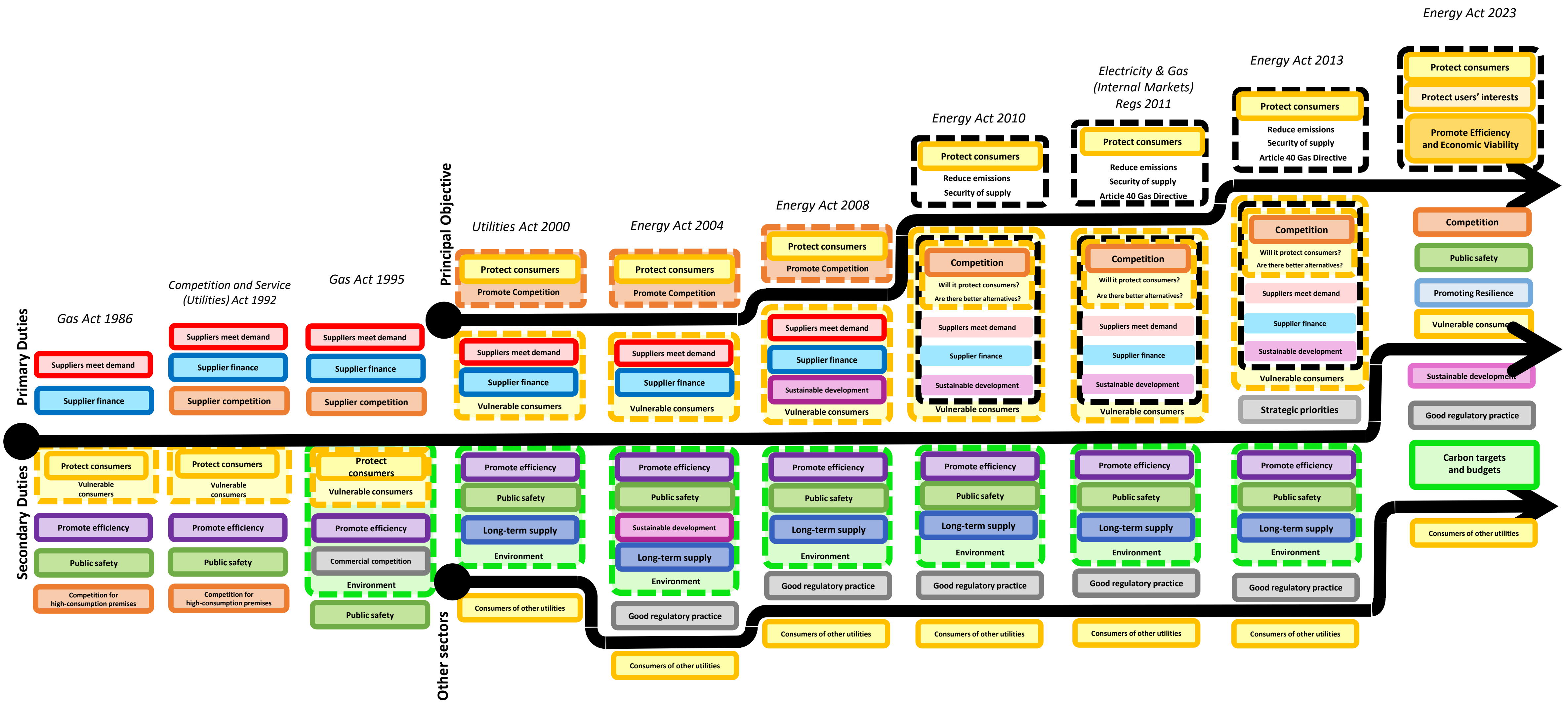
- Stephen Littlechild as academic and regulator expressed expectation that regulation was temporary to be superseded by competition
- And that the ultimate beneficiaries were consumers:
  - "Ask not what your consumers can do for you, ask what you can do for your consumers" (Littlechild, 2018)
- Consumers initially passive beneficiaries and actors within regulation and competition

Energy Regulator's initial duties

- Looks very much like a standard principal-agent setup enabling the firm to finance its activities (participation constraint);

  and be residual claimant of cost savings, subject to RPI-X combined with periodic review of the latter (incentive compatibility constraint)
- Key assumptions:
  - firms maximise profits
  - The regulator is able to identify an appropriate "X"
- Role of consumer very limited – choice between payment methods – protected from price level and discrimination

Shift in focus for the (energy) regulator from efficiency to consumer protection

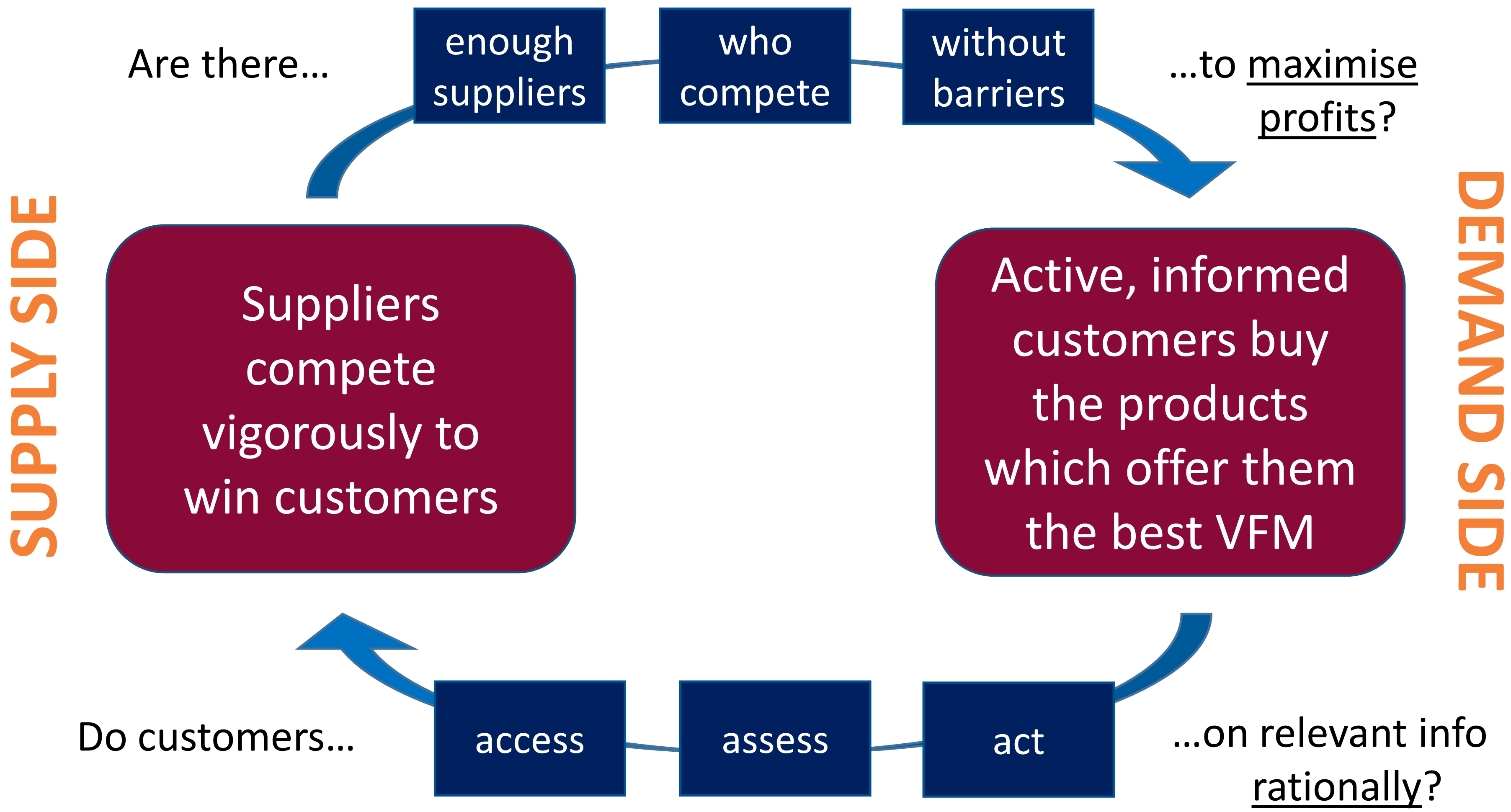


Competition could offer greater choice and discipline/protection

- Post 1997 change in priorities – consumer objective becomes primary
  - primacy of competition as preferred instrument especially energy (2010 washup debate)

- Competition introduced in retail energy 1998-2000
- Price caps removed 2002
- Expectation that market would be well-functioning

OFT model of a well-functioning market

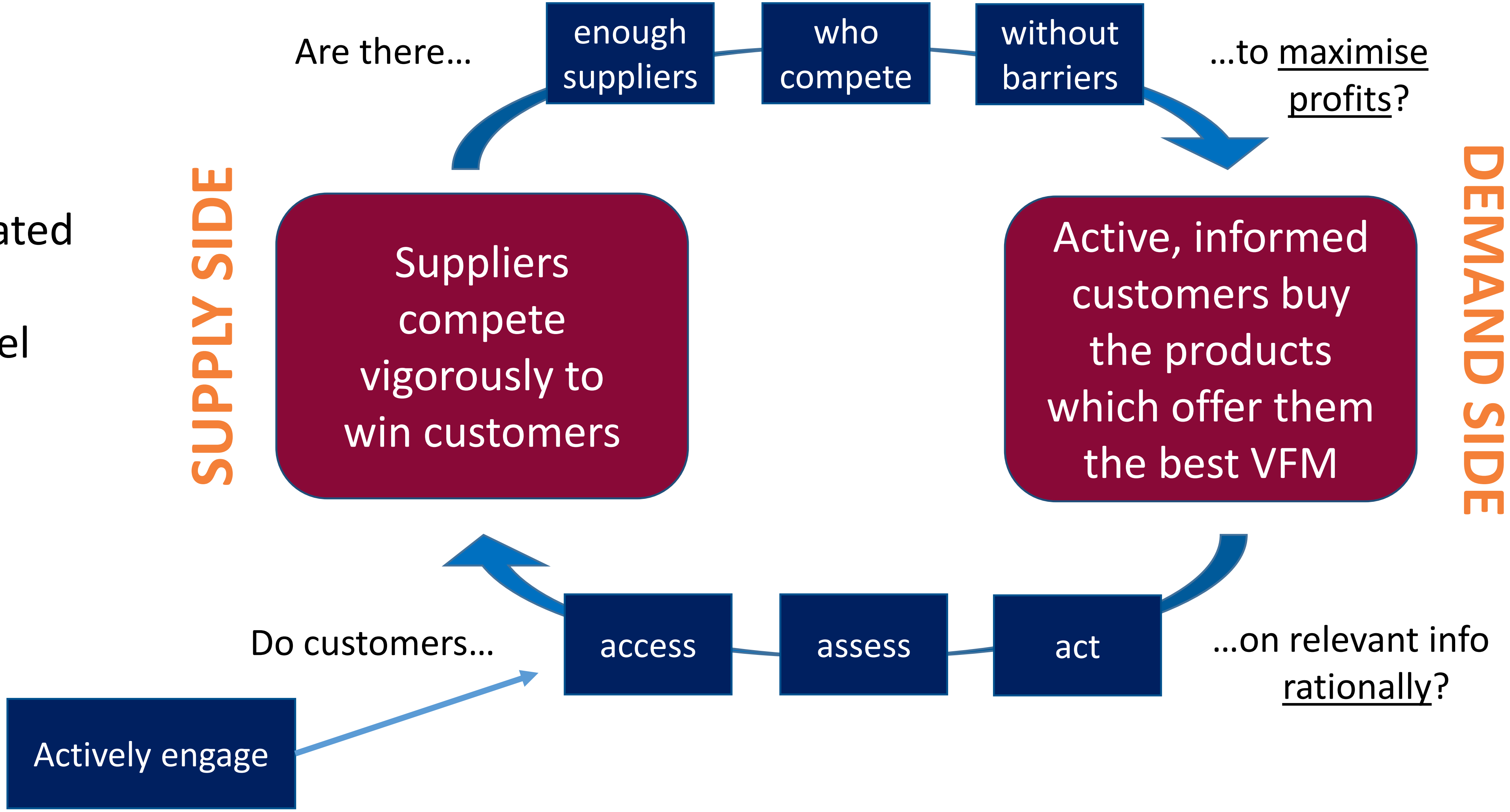


The supply side looks promising

- Challenge for potential entrants: How to fund fixed entry costs if markets were really well-functioning?
  - Homogeneous goods imply fierce post-entry competition
  - Little from adjacent sectors [e.g. oil]
- But not all consumers responded quickly to better offers
- Entry of rival firms, especially into each others’ home markets
- No evidence of overt collusion

Consumers play a key role in a well-functioning market

Updated OFT model



Consumers can be the problem as well as the beneficiary

- Not all consumers engage actively [switching rates low]
- Where they access information, they no not always assess it correctly and when they act, they make mistakes [Wilson and Waddams Price]
- Where they engage, access and assess information they do not always act, even where the cost of doing so is minimal [big-switch]
- Heterogeneity between and within subgroups of consumers hinders remedy identification/implementation [Waddams Price and Zhu]

A new perspective of Consumers as the problem

- Policy focus on consumer behaviour (Ofgem from 2008)
- The CMA report in 2016 focused on consumer behaviour as itself a feature of the market which was inhibiting the development of competition
  - Though without some inertia, competition may also not exist
- Majority report favoured remedies to encourage consumer activity, Minority report recommended (temporary) price cap
- Regulators now have a behavioural economics [psychology] unit

Allowing for behavioural consumers is challenging

- Test interventions, ideally with Randomised Control Trials
- What can regulators and regulated firms legitimately assume about consumers, beyond internal consistency?
- Biggest challenge is dealing with heterogeneity across and within consumer groups
  - Who is engaged, who accesses and assesses information and does so correctly, who is prepared to act on this?
  - Distinguish can’t switch from won’t (can’t be bothered)?
  - Cost to consumer of engagement

Rethinking regulation with behavioural consumers

- The regulation framework belatedly moved consumer to the top of the formal regulatory objectives table
- Consumer behaviour both more important and more challenging than expected when UK started this journey
- **Less regulation?** to disinhibit/empower consumers
  - How to actively engage consumers when the product is invisible and fundamentally homogeneous or
- **More?** to protect them

Thank you

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Anti-discrimination intervention ?

- Being active is costly and needs an incentive
- Generates differences if only active consumers benefit
  - unless they make mistakes
- How big a difference between active and passive consumers is acceptable?
- Intervention: non-discrimination clauses
  - Which in this case weakens competition