Competition, not Concentration

Creating Better Consumer Markets

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SMF Social Market Foundation

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Scott was voted one of the top three forecasters of UK GDP by Focus Economics in 2016.

EXECUTIVE SUMMARY

This report explores issues of concentration and competition in consumer markets, and the role that policymakers can play in driving improved outcomes for UK households in these markets.

Our 2017 report, *Concentration, Not Competition,* showed that a sizable proportion of the UK's most important consumer markets are concentrated – dominated by a small number of large incumbents. The lack of competition associated with industry concentration in turn generates a range of negative economic outcomes for consumers. This includes higher prices, poorer customer service and a lack of choice.

More subtly, excessive levels of industry concentration may deter innovation in the economy and drive up inequality as wealth gathers in a small number of businesses.

Scepticism about markets is rife at present. Opinion polls show a majority of individuals favouring nationalisation of the energy, water and rail industries. This stems at least partly from dissatisfaction with the outcomes that these markets are perceived to be delivering for consumers – such as high prices and poor customer service.

Proponents of markets need to recognise the shortcomings that are driving this discontent. Rather than criticising the nationalisations and big government approaches being proposed by others, market proponents need to start focusing more on offering compelling solutions to the inadequacies of some of our consumer markets, particularly those that are caused by a lack of competitive pressures on large incumbent companies.

At present, too often it feels as if the electorate is being offered a choice between re-nationalisation and big government, and *corporatism* – the domination of the economy by large private companies, who in turn use all the lobbying tools at their disposal to ensure that policy and regulation act in their interests, rather than the interests of wider society. We need a new policy framework that focuses on and champions *competition* and provides a clear alternative to both corporatism and nationalisation.

Government and regulators need to explore how they can use the policy tools at their disposal to boost competitive pressures in consumer markets and generate better outcomes for UK households. This report recommends:

1. **Measuring and tracking industry concentration and competition on an ongoing basis -** At present, a lack of data is holding back understanding, debate and policymaking on market concentration and competitiveness and their impacts on the economy. To raise awareness of levels of industry concentration, and encourage more widespread research in this space, we recommend that regulators publish a commonly-agreed and comparable measure of industry concentration (such as the Herfindahl-Hirschman Index) on a regular basis. At a minimum, we would expect this data to be published on an annual basis.

2. **Creating a Minister for Consumers, Competition and Markets -** The Minister for Consumers, Competition and Markets would be responsible for leading the efforts of the Government in improving consumer outcomes in markets, driving increased

levels of competitiveness and minimising negative outcomes associated with excessive levels of market power held by large incumbents.

The role of a Minister for Consumers, Competition and Markets would be particularly important in the context of Brexit. The UK and EU institutions have shared responsibility for competition matters, and Brexit could have a significant impact on the UK's domestic competition regime in the future. Government needs to be prepared for this.

3. **A "presumption in favour of competition" at the heart of M&A policy – putting consumer interests first -** At present, when considering whether to permit a merger, the Competition and Markets Authority (CMA) identifies possible "theories of harm" – ways in which the merger might lead to worse outcomes in a consumer market – such as a substantial loss of competition and higher consumer prices. If these theories of harm are considered likely to occur, and no credible remedies to these harms can be implemented, then the CMA can prevent a merger going ahead.

   While the "theories of harm" approach to assessing mergers has helped prevent detrimental mergers going ahead, we note some of the inherent challenges and judgment calls involved in the process. Assigning probabilities to theories of harm is often a subjective process with significant uncertainties – meaning that mergers may be permitted when the *actual* probabilities of harm to consumers are inherently greater. This is not a criticism of the CMA's processes, but an inherent challenge with assigning probabilities to economic events.

   As well as difficulties associated with assigning probabilities to harms, there are challenges associated with measuring the *scale* of harms, particularly when harms may take several years to materialise. One type of harm that is difficult to measure, for example, is what economists call "X inefficiencies" – inefficiencies that arise when firms behave in a sub-optimal manner due to a lack of competitive pressure. Similarly, the net impacts of product bundling on consumer markets are often difficult to establish. While bundling following a merger may enable efficiency savings and lower costs for consumers, it can also act as a barrier to switching and make it harder for new entrants to compete in a market.

   Our preference is for the "theories of harm" framework to be replaced with a new "presumption in favour of competition" – under which the CMA would be expected to prevent mergers in the most concentrated markets – unless it could be demonstrated that there was a strong chance of the merger leading to improved outcomes for UK consumers (for example lower prices, better service quality and higher levels of product innovation) while not undermining competition.

   Under this M&A policy framework, we would expect the interests of UK households to be better assured than under current arrangements, with a much clearer emphasis on consumer interests.

4. **Boosting competition through data – consumers should own and be able to access and share personal data -** Allowing consumers to easily obtain digital records of

their energy and telecommunications usage, and associated charges, would facilitate the development of new apps and internet tools to guide, encourage and automate supplier switching. For example, algorithms can be developed which recommend products to individuals based on usage and charges. Regulators would need to play a key role in ensuring data provision is standardised in a way that enables such an infrastructure of apps and algorithms to develop.

In financial services, the sharing of account data via Open Banking could lead to better and more rapid overdraft and loan deals for consumers, by making it easier for individuals to prove their creditworthiness. Open Banking would also allow the development of new online and phone apps which let an individual view financial products from multiple banks in one place. By making it more convenient to have multiple financial service providers, and providing more distance between consumers and bank brands, we would expect Open Banking to lead to a more competitive financial services market.

Government and regulators need to ensure that Open Banking is able to develop in a way that sees the creation of such apps, at a competitive price, which can help increase competition in financial services.

5. **Bank of England style reporting of market concentration.** We would like to see explicit targets placed on regulators by government to reduce the levels of industry concentration and boost competition in some consumer markets, with regulators expected to report regularly to our proposed Minister for Consumers, Competition and Markets on:
    a. Trends in industry concentration (as measured using the Herfindahl-Hirschman Index (HHI)) and whether it is moving closer to or further away from government targets.
    b. Trends in customer switching rates
    c. Trends in company profit margins for specific consumer products, such as electricity, gas, broadband and telephony.

6. **Automatically switching sticky customers to challenger companies in the energy and fixed-line telephony markets –** We would like to see an automatic switching scheme introduced, whereby regulators, the State or another non-profit entity automatically switches "sticky" customers to new, cheaper challenger providers.

    For example, in the energy market, individuals that have been on a standard variable tariff for more than three years would be automatically switched to a cheaper provider that is not part of the "Big Six" group of large incumbent energy companies. Such a move would improve consumer outcomes in the sector, and broaden out the energy market so it is less dominated by large incumbents. Once industry concentration has declined sufficiently, we would expect Big Six suppliers to also be able to compete in the automatic switching process.

    We propose a similar scheme be adopted with respect to those that are on fixed line-only telephone contracts, with automated switching to a cheaper provider that is not British Telecom.

The default would be that individuals are opted into the schemes. They can choose to opt out in they wish.

7. **"Click in, click out" – ending the asymmetry between subscribing and unsubscribing.** Companies often make it harder to unsubscribe to a product than to subscribe, creating barriers to abandoning products that are poor value or of low quality. For example, while it may be possible to subscribe to a broadband package or pay TV on the internet, unsubscribing often requires an individual to make a telephone call to the company.

   We would like to see this asymmetry removed from consumer markets. One simple way of doing this is for the government and regulators to require companies to have a symmetric approach to subscription and unsubscription – if it is possible to sign-up online to a product, such as a pay TV or broadband service, it should be possible to unsubscribe online.

CHAPTER 1: INTRODUCTION

The political economy of the UK is at a critical juncture. Politicians, the media and the public are increasingly questioning the desirability of an economic system which appears to be struggling to achieve strongly growing real incomes for a significant number of households. High prices and poor customer service pervade some consumer markets. At the same time, the economy is dogged by lacklustre productivity growth, low levels of investment compared with other developed economies and employee wages which remain lower in real terms than before the financial crisis.

Many of these problems are at least partly driven by markets which are far removed from the economic ideal of "perfect competition". All too often, some of the UK's most important consumer markets are concentrated in the hands of a small number of companies, which face fewer pressures to reduce prices, cut costs, invest and innovate than they would in a more competitive market. In such circumstances, a *laissez faire* approach to the economy is unlikely to lead to optimal or even good outcomes for consumers.

Furthermore, industry concentration and a lack of competition contribute to another key economic issue at this juncture: inequality. If profits accumulate in the hands of a small number of businesses this can drive increased levels of inequality. More competitive markets entail a greater spread of wealth and, in turn, lower levels of inequality.

In our 2017 report, *Concentration: Not Competition,* Social Market Foundation (SMF) analysis showed that eight of the 10 consumer markets considered were "concentrated" – dominated by a small number of large incumbents. Furthermore, we argued that in several of these markets there is a clear link between market concentration and competitiveness. Where markets are concentrated, there is often evidence of relatively little competition taking place between firms – for example on price or product quality.

The direction of causality here potentially works in both directions. Companies with a high degree of market power may undermine competition through substantial supply chain bargaining power and access to a large pool of customer data. These factors give the dominant company a significant competitive advantage, making it harder for other companies to enter and grow in a market.

Working in the other direction, markets where competitive pressure is weak (for example because consumer switching rates are low) are likely to gravitate towards relatively high levels of industry concentration.

For those of us that believe a market-oriented economy is generally much more effective than a State-controlled one in driving innovation, competition and rising standards of living, the underwhelming performance of many consumer markets should be a source of great concern. Unless markets start to deliver better outcomes for consumers, they risk undermining their very existence, as an increasing proportion of the electorate lose faith in market-based economics – instead preferring nationalisation and State control of key industries such as energy, banking and telecommunications.

To restore greater levels of faith in consumer markets, significant reform and innovation is necessary. Making markets more competitive, dynamic and less concentrated needs to

be a priority issue for the Government, if it wishes to improve living standards, bolster productivity and provide a compelling alternative to Statism. This report sets out a series of policy solutions which we believe would go a significant way towards revitalising consumer markets, boosting competition and supporting economic growth in the process.

The structure of the report is as follows:

- **Chapter 2** provides a brief overview of findings from the first part of our research on concentration and competition in UK consumer markets.
- **Chapter 3** outlines a set of policy recommendations aimed at addressing the issues identified in our research.
- **Chapter 4** draws conclusions from the preceding analysis.

CHAPTER 2: CONCENTRATION, NOT COMPETITION. A SUMMARY OF OUR PAST RESEARCH

In our report *Concentration, not Competition* we undertook new analysis of the extent to which consumer markets are competitive and concentrated, and examined the extent to which levels of competition and concentration had changed over time. The analysis examined the following 10 key consumer markets, which collectively account for about 40% of all consumer spending: cars, groceries, broadband, mobile telephony, landline-only phone contracts, electricity, gas, personal current accounts, credit cards and mortgages.

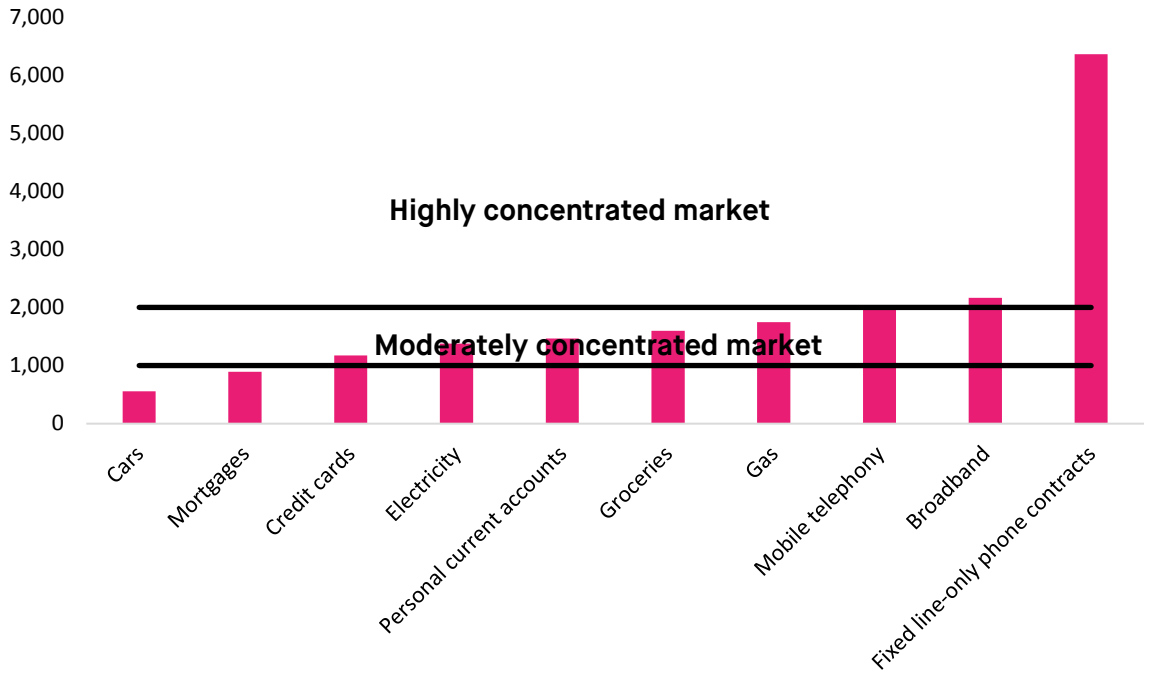
The key measure of market concentration considered in the report was the Herfindahl-Hirschman Index (HHI) – defined as the sum of the square of company market shares in each consumer market. The higher the HHI score, the more concentrated a market is. For example, a market which contains only one company has an HHI score of 10,000. A market with four firms each with a market share of 25% has an HHI score of 2,500. We consider a market with an HHI score of less than 1,000 to be unconcentrated, with a score of 1,000 to 2,000 to be moderately concentrated and with a score above 2,000 to be highly concentrated. These thresholds are in line with those in the European Commission's guidelines on the assessment of horizontal mergers – Commission notice (2004/C31/03).

Our analysis suggested that industry concentration pervades some of the most important consumer markets:

- **Eight of the ten consumer markets examined were "concentrated"** [1] **in 2016, meaning they are dominated by a small number of large companies.** Only cars and mortgages can be considered unconcentrated consumer markets.
- **In telecommunications, market concentration is high and it has increased over the past decade with respect to broadband and mobile telephony.**
- **The personal current account market is more concentrated than in 2007 with the market dominated by the five largest banks.** This is despite recent entrants into the market.
- **The gas and electricity markets have become less concentrated since the early 2000s, with a number of new entrants in the sector.** However, the market remains dominated by the "big six" energy companies.
- **Concentration in the groceries market has declined in recent years.** The rise of Aldi and Lidl in recent years has eroded the market share of the "big four" supermarkets and reduced industry concentration.

[1] On the Herfindahl-Hirschman Index (HHI) measure of industry concentration

Figure 1 Estimates of industry concentration in consumer markets, HHI score, 2016



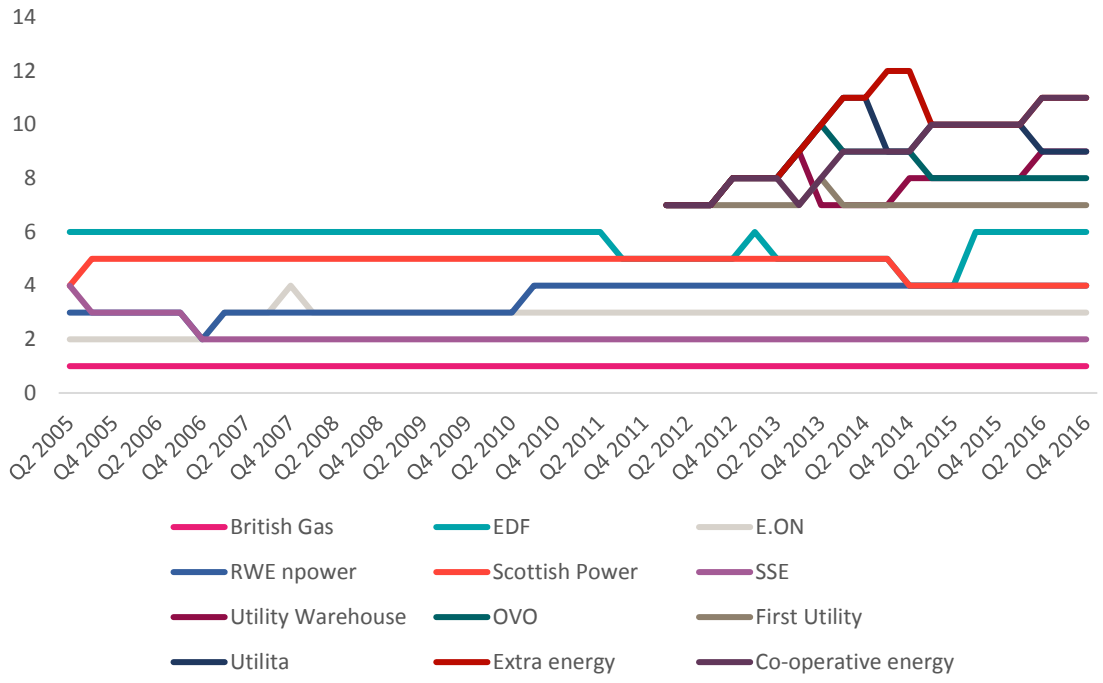
Source: SMF analysis. Data point for personal current accounts relates to 2015, while data point for credit cards relates to 2014, given data limitations

Concentration and competition are not the same thing, nor do they need to coincide with one another. For example, the groceries market appears to be relatively competitive – with significant price competition between firms – despite it being a moderately concentrated market. However, in other markets, lack of competition and high levels of industry competition appear to go hand in hand.

One gauge of how competitive consumer markets are is the extent to which companies climb up and move down the market share "league table". In a competitive market, it is reasonable to expect fairly regular changes in ranking between companies, as those lower down the league table gain market share by improving their service offer in terms of pricing and product quality. In an uncompetitive market, rankings of companies are likely to be relatively rigid, reflecting advantages held by some firms, a lack of consumer switching and barriers to market entry. In such circumstances, it may be difficult or impossible for smaller companies to significantly grow their market share, even if they develop a compelling and well-priced product offer.

To give an example, in energy, British Gas/Centrica has consistently had the largest market share for electricity and gas. Its market share lead in electricity has increased since 2004, though its lead for gas has diminished. While new entrants into the utility markets have reduced the market share of the "big six" energy companies, these established firms for now enjoy a substantial market share lead over the new entrants. Furthermore, the relative ranking of the big six energy companies does not change regularly over time, suggesting little in the way of competitive forces.

Figure 2 Ranking of gas suppliers, in terms of market share



Source: SMF analysis

In telecommunications, BT has a substantial market lead in fixed-line only phone contracts, with a market share of about 80%. Competition is extremely weak, given that the demographic of fixed-line only customers disproportionately consists of relatively vulnerable consumers – in particular the elderly and those on low incomes. These individuals are likely to be less engaged with markets and less inclined to switch supplier. Indeed, the lack of effective competition in this market has led Ofcom, the telecommunications regulator, to impose a price cut for landline-only customers[2].

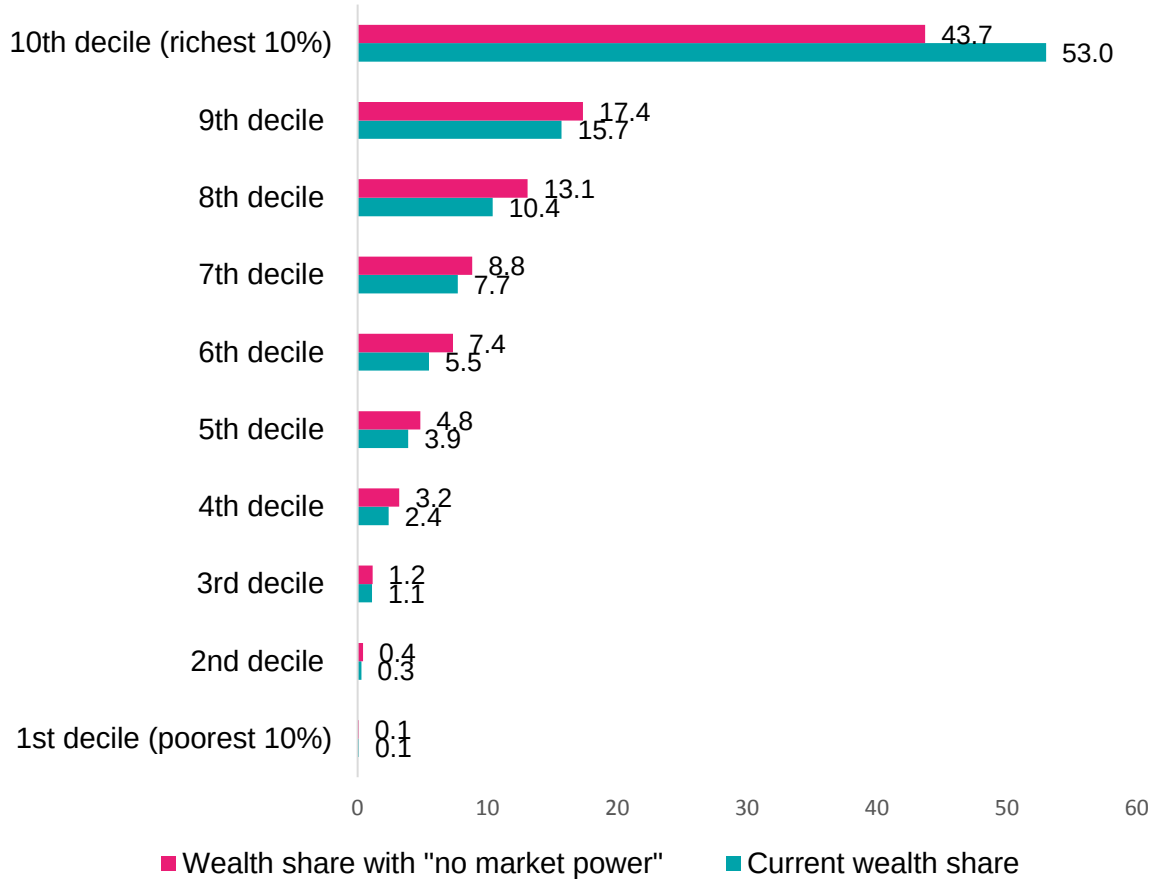
Our analysis found that a lack of competition in consumer markets is resulting a range of negative outcomes for UK households:

- **Lack of choice -** in concentrated markets, consumers may not have access to the diversity of product and service choices that they would like.
- **Poorer customer service and lower levels of trust** – we identified a link between higher levels of market concentration and lower levels of customer service and trust in markets.
- **Higher prices –** where markets are more concentrated, consumers often face higher prices.
- **"Supernormal" profits and underinvestment –** Where competition is weak, company profits margins are likely to remain higher than would otherwise be the case. The presence of supernormal profits contributes to an unequal distribution

[2] https://www.ofcom.org.uk/about-ofcom/latest/media/media-releases/2017/bts-landline-only-customers-set-for-cheaper-bills

of wealth and income in the UK, raising questions around social justice and fairness. Indeed, analysis by the OECD, graphed below, suggests that reducing market power in the UK would lead to a more even distribution of wealth:

Figure 3 Impact of market power on the wealth distribution in the UK, %



Source: OECD (2017), "Competition Policy for Shared Prosperity and Inclusive Growth", Table 5.17

Where companies face only limited competitive pressure because their market is concentrated, they may be less likely to spend their money on things that might allow them to offer a better, cheaper service or product to customers. Instead of investing and innovating, UK corporations often sit on substantial cash reserves, a trend we believe is being exacerbated by market concentration.

In our report, we identified seven key drivers of concentration and a lack of competition in consumer markets in the UK:

1. **Barriers to entry in markets** - high fixed costs and regulatory/licencing requirements may deter new entrants into consumer markets.

2. **Barriers to scaling up** - for example, energy companies face significant environmental and social obligations once they exceed 250,000 customers. Regulatory and licencing requirements for financial services firms can deter entrants from providing new products and services.

3. **Bundling and gateway products -** bundling of services has become much more prevalent in the telecommunications sector. Similarly, the dominance of dual fuel energy tariffs may undermine competition in the gas and electricity markets. Bundling can decrease the likelihood of an individual switching supplier for a given product, given the need for them to "unbundle" and choose new products for other services.

   In banking, personal current accounts may act as a "gateway product", with individuals more likely to opt for a loan, credit card or mortgage from institutions with which they hold a current account.

4. **Low switching rates -** Low switching rates make it much harder for new entrants to grow their market share significantly. For example, data from Bacs show that less than two per cent of current account holders switch accounts each year.

5. **Incumbent advantages -** For example, in the retail sector, incumbent firms have significant supply chain bargaining power, allowing them to purchase goods and services at a lower price than a new entrant to a market. This can make it difficult for a new company to compete on price with a larger firm.

6. **Natural monopolies -** There are some industries where there is an inherent natural tendency towards monopolies or limited competition. For example, rail transport often inherently lacks consumer choice given the challenges associated with having multiple train providers on some routes. The introduction of competition in these instances may actually lead to inefficiencies compared with a monopoly situation.

7. **Uncompetitive sub-markets** - An example of this is "mortgage prisoners" who are unable to switch mortgage - for example, because they are in negative equity. These individuals can find themselves facing relatively high interest standard variable rate (SVR) mortgages which they are unable to switch out of.

Tackling these drivers of industry concentration should be a focus for policymakers interested in increasing the level of competition in markets (given the links between competition and concentration in markets). In the next chapter of the report, we set out a range of policy recommendations aimed at addressing these drivers.

CHAPTER 3: THE POLICY RESPONSE

Given the negative outcomes associated with excessive levels of industry concentration and low levels of competition, we believe that there is a compelling case for new, and radical, policy intervention. By broadening out our consumer markets, and making them more competitive, government can drive better outcomes for UK households and provide a compelling alternative to nationalisation and Statism.

At present, too often it feels as if the electorate is being offered a choice between re-nationalisation and big government, and *corporatism* – the domination of the economy by large private companies, who in turn use all the lobbying tools at their disposal to ensure that policy and regulation act in their interests, rather than the interests of wider society.

We need a political and policy framework that champions *competition* and distribution of the means of production, over both *corporatism* and *Statism* – both of which ultimately favour concentration over distribution of economic power. Below we discuss a range of policy recommendations which could form key components of such a pro-competition framework.

Recommendation 1: Measuring and tracking industry concentration and competition on an ongoing basis

One barrier to having an ongoing and robust debate about the impacts of industry concentration and competition – for consumers and the wider economy - is a lack of available data.

As we discovered in our research for our *Concentration, Not Competition* report, there is a dearth of regularly reported data on levels of industry concentration in consumer markets, and the UK economy more widely. This limited some of the analysis we were able to undertake in *Concentration, Not Competition* – for example, we were not able to examine levels of and trends in market concentration in the UK pay-TV market, due to a lack of regular publicly available data on pay-TV market shares.

Reports and data from the Office for National Statistics (ONS) on industry concentration have only been produced sporadically[3], and this data has been presented in a way that it not particularly relevant to the types of markets faced by UK consumers. For example, ONS-published concentration ratios have focused on the concentration of industry in terms of turnover and economic gross value added (GVA), rather than consumer market shares. This means the data is impacted by exports and income earned overseas and does not necessarily paint a picture of the level of concentration in *UK* consumer markets.

While regulators such as Ofgem, Ofcom and the Financial Conduct Authority (FCA) have produced more relevant measures of industry concentration in consumer markets, these are often not published on a regular basis. For example, industry concentration metrics such as the Herfindahl-Hirschman Index are often only produced when considering the implications of a merger or acquisition, or undertaking a detailed market review for some other purpose.

[3] For example, ONS (2006), "Concentration ratios for businesses by industry in 2004"

The lack of available data on concentration in consumer markets constrains the amount of research that can be undertaken by academics, journalists, think tanks and policymakers on the economic implications of concentration. For example, while we can intuitively argue a potential link between industry concentration and reduced levels of investment, productivity and dynamism in the economy, it is not possible to produce robust econometric estimates of the relationship with the data we have at hand. Without a more solid understanding of trends in industry concentration and their implications, informed policymaking is in turn constrained. Bluntly, the absence of easily-understood authoritative measures of competition and concentration means that politicians are less likely to consider and discuss those things and their implications.

To raise awareness of levels of industry concentration, and encourage more widespread research in this space, we recommend that regulators publish a commonly-agreed and comparable measure of industry concentration (such as the HHI) on a regular basis. At a minimum, we would expect this data to be published on an annual basis, on the websites of the market regulators, the Competition and Markets Authority and possibly the Office for National Statistics. Data on market concentration should be provided across product categories within an industry. For example, we would expect the FCA to produce regular estimates of the HHI for the personal current account, credit card, personal loan and mortgage markets. We would expect Ofcom to produce HHI scores for the broadband, landline, mobile and pay TV markets. In addition, we would expect HHI scores to be produced for *sub-markets* for a given product – for example, in the energy market, we would expect HHI scores for the pre-payment meter market, and the sub-market of relatively "disengaged" customers that are on relatively poor value standard variable tariffs. These sub-markets can have very different competition and market concentration dynamics than other sub-markets, and this is something that should be explorable in official datasets.

As well as regularly reported measures of concentration, we would also like to see greater prominence and regularity given to indicators tracking how well consumer markets are functioning, including measures of profit margins, consumer prices and switching rates. We would like to see greater consistency in how these datapoints are collated and presented by regulators – at present, such data is "patchy". For example, while data on energy market and personal current account switching is regularly published, the same cannot be said of switching in the telecommunications market. Ofcom does not publish a regular dataset of mobile, broadband or pay TV switching.

At present, a lack of data is holding back understanding, debate and policymaking on market concentration and competitiveness and their impacts on the economy. This ought to change.

Recommendation 2: A Minister for Consumers, Competition and Markets

Government needs to re-affirm its commitment to a market-based economy, and to demonstrate clearly that its underlying preference is for *competitive markets* rather than uncompetitive, concentrated *corporatism* or *nationalisation.*

A relatively straightforward way of showing this commitment to competitive markets, and a commitment to improving consumer outcomes in markets, is by creating a *Minister for Consumers, Competition and Markets*.

The Minister for Consumers, Competition and Markets would be responsible for leading the efforts of the Government in improving consumer outcomes in markets, driving increased levels of competitiveness and minimising negative outcomes associated with excessive levels of market power held by large incumbents.

The ambition of the Minister for Consumers, Competition and Markets should be for the UK to have some of the world's most competitive consumer markets, where there is significant demand-side pressure on suppliers to reduce prices and offer high levels of customer service. The Minister would take on many of the competition and market functions held currently by the Secretary of State for Business, Energy and Industrial Strategy.

The role of a Minister for Consumers, Competition and Markets would be particularly important in the context of Brexit. The UK and EU institutions have shared responsibility for competition matters, and Brexit could have a significant impact on the UK's domestic competition regime in the future. Government needs to be prepared for this.

A recent Lords Select Committee report noted that while there should continue to be consistency between the UK and EU's approach to competition matters, the UK will be free to take a more innovative and responsive approach to tackling global competition enforcement challenges, such as fast-moving digital markets and dominant online platforms[4]. Transitional arrangements will be necessary to clarify jurisdiction in cases which are "live" at the point of Brexit, as well as future cases relating to conduct which occurred while the UK was still a member of the EU.

Furthermore, after Brexit, a UK-wide domestic State Aid framework will be needed in order to meet World Trade Organisation (WTO) obligations and avoid intra-UK subsidy races among the devolved administrations. It will be essential for the Government to involve and secure the support of the devolved administrations in developing this framework.

We would expect a Minister for Consumers, Competition and Markets to play a key role in establishing and overseeing the UK's post-Brexit competition regime.

To support the role of the new Minister, and in recognition of an increased domestic role in deciding competition policy, we would expect some expansion of the Department for Business, Energy and Industrial Strategy to meet new post-Brexit requirements. We note that the Competition and Markets Authority (CMA) is currently expanding in line with increased resource requirements following Brexit[5].

[4] https://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-internal-market-subcommittee/news-parliament-2017/brexit-competition-and-state-aid-report-published/
[5] See, for example, https://www.gov.uk/government/news/scotland-to-benefit-from-cma-expansion

Recommendation 3: A "presumption in favour of competition" at the heart of M&A policy – putting consumer interests first

When considering the implications of mergers and acquisitions in consumer markets, regulators undertake detailed assessments and consultations to establish the potential implications for consumer outcomes and market competitiveness. This analysis is thorough, rigorous and provides a valuable safety net to prevent mergers and acquisitions which undermine competition, and which potentially lead to higher consumer prices and reduced levels of product innovation.

At present, when considering whether to permit a merger, the Competition and Markets Authority identifies possible "theories of harm" – ways in which the merger might lead to worse outcomes in a market[6] – such as a substantial loss of competition and higher consumer prices. If these theories of harm are considered likely to occur, and no credible remedies to these harms can be implemented, then the CMA can prevent a merger going ahead.

While the "theories of harm" approach to assessing mergers has helped prevent detrimental mergers going ahead, we note some of the inherent challenges and judgment calls involved in the process. Assigning probabilities to theories of harm is often a subjective process with significant uncertainties – meaning that mergers may be permitted when the *actual* probabilities of harm to consumers are inherently greater. This is not a criticism of the CMA's processes, but an inherent challenge with assigning probabilities to economic events.

As well as difficulties associated with assigning probabilities to harms, there are challenges associated with measuring the *scale* of harms, particularly when harms may take several years to materialise. One type of harm that is difficult to measure, for example, is what economists call "X inefficiencies" – inefficiencies that arise when firms behave in a sub-optimal manner due to a lack of competitive pressure. Similarly, the net impacts of product bundling on consumer markets are often difficult to establish. While bundling following a merger may enable efficiency savings and lower costs for consumers, it can also act as a barrier to switching and make it harder for new entrants to compete in a market.

Given the inherent uncertainties associated with establishing the likelihood and scale of harms to consumers following mergers and acquisitions, our preference is for the "theories of harm" framework to be replaced with a new "presumption in favour of competition" – under which the CMA would be expected to prevent mergers in the most concentrated consumer markets – energy, groceries, banking and telecommunications – unless it could be demonstrated that there was a strong chance of the merger leading to improved outcomes for UK consumers (for example, lower prices, better service quality and higher levels of product innovation) while not undermining competition.

The distinction between the current and our proposed policy framework may sound subtle at first glance, but the implications are potentially significant. For example, while the recent merger of BT and EE was granted under the CMA's theories of harm framework, it

[6] https://www.regulation.org.uk/competition-merger_control.html

could have struggled to gain approval under a "presumption in favour of competition" framework.

Under this M&A policy framework, we would expect the interests of UK households to be better assured than under current arrangements, with a much clearer emphasis on consumer interests.

Recommendation 4: Personal data – consumers should own it and be able to share it

Data has the potential to increase competition and reduce levels of concentration in consumer markets – but only if there is open access to such data. If data is hoarded, for example by large incumbents that hold vast pools of consumer information, it can ultimately lead to reduced competition and worse outcomes for consumers. For example, as mentioned in the previous chapter, having a significant "data advantage" makes it easier for incumbents to compete in a market compared with new entrants. Data on consumer behaviours can also pave the way for greater levels of price discrimination where, for example, customers less likely to switch supplier see higher prices than those that are more price sensitive.

Regulators are currently exploring how to better use data to improve competitiveness in consumer markets. For example, Ofgem is constructing a secure "disengaged customer" database. This database contains information on consumer tariffs, energy usage, and customer names and addresses. Ofgem is currently exploring how this database can be used to target customers that have been on poor value energy deals for a long period of time – for example by inviting them to participate in a collective energy switch[7].

In financial services, Open Banking has the potential to drive product innovation and better consumer outcomes. Open Banking refers to technologies and standards which allow consumers to give companies other than their bank or building society permission to securely access their accounts. This is expected to lead to some significant innovations in the banking market. For example, Open Banking should pave the way for the development of online and mobile phone apps that allow an individual to view details from all of their financial service providers in one place. That is, Open Banking eliminates the need for an individual to have an app for *each* financial service provider.

Furthermore, Open Banking could lead to better and more rapid overdraft and loan decisions. By allowing companies to access an individual's account data, more accurate and rapid credit scoring assessments can be made. For individuals that currently struggle to prove their credit worthiness, for example due to a lack of credit history, Open Banking can therefore translate into cheaper borrowing costs.

Open Banking may also allow sophisticated algorithms to be developed which provide recommendations to consumers about, for example, choice of personal current account provider and other financial decisions.

Open Banking may also reduce the chance of personal current accounts acting as a "gateway product", with some consumers more inclined to acquire loans, mortgages and

[7] https://www.ofgem.gov.uk/consumers/household-gas-and-electricity-guide/how-switch-energy-supplier-and-shop-better-deal/ofgem-disengaged-customer-database

other financial products from the company with which they hold a current account. Online apps which allow individuals to manage financial accounts and products across a range of companies would reduce inconveniences associated with having multiple financial service providers – such as the inconveniences associated with multiple logins and numerous mobile phone apps. In addition, they provide greater separation between customers and bank brands. Government and regulators need to ensure that Open Banking is able to develop in a way that sees the creation of such apps, which can help increase competition in financial services.

We would like to see further innovation with respect to data, including establishing a disengaged customer database in the fixed line telephone market, to enable automated switching of sticky customers in this market. We would also like to see the sharing of appropriately anonymised disengaged customer databases with a range of third parties. For example, consumer charities such as Citizens Advice may be able to better advise consumers through the information contained in such databases.

Furthermore, we would like to see new ownership and sharing principles around personal data in consumer markets, with the principles of Open Banking extended into other markets. Consumers should be the owners of personal data collected by companies, and they should be able to easily and freely request a digital copy of this data. For example, in the energy market individuals should be able to easily acquire data relating to their energy usage, and the costs they incur for this usage, in a digital format that they can share (if they wish) with other companies and price comparison websites. Similarly, with the telecoms market – it should be easy for customers to acquire data on their mobile and broadband usage, and the costs they are incurring.

We would expect the CMA, individual market regulators and our proposed Minister for Consumers, Competition and Markets to play key roles in setting out this approach to data ownership, including standardisation of data provision into consistent formats that can be readily used by consumers and organisations with which consumers wish to share their data.

We note that the implementation of General Data Protection Regulation (GDPR) in 2018 will require data controllers to provide “data portability” when accounts are closed – allowing individuals to potentially use this data to switch supplier more easily and locate a better deal on the market.

We envision open, readily available data driving increased switching rates in a range of markets, such as energy, telecoms and personal current accounts. For example, in telecoms, open data could lead to the development of websites and apps which provide tailored product recommendations to customers based on their broadband and mobile usage. Indeed, there is potential for apps to go further, using data to carry out the switching process seamlessly.

Data standards and format are clearly important in driving change. It needs to be “app friendly” if it is to drive the creation of new price comparison and switching products – highlighting the need for government and regulator involvement in this space.

Recommendation 5 HHI targeting: Bank of England style reporting of market concentration and competitiveness

As discussed, we need a more lively debate about concentration and competition in consumer markets – in the media, among politicians and academics, and among UK households.

A government fully-committed to making consumer markets more effective should put competition right at the heart of policymaking and communication – regularly reporting on trends in consumer markets and explaining what actions, if any, the government and regulators are undertaking to remedy underlying problems.

One way we would like to see greater prominence given to figures on industry concentration, profits and consumer outcomes is for the government to adopt a Bank of England inflation-targeting style approach to correcting some of the ills in consumer markets. Much as the Government sets an inflation target which the Bank of England is expected to use its policy levers to achieve, the Government could apply industry concentration/competitiveness targets for regulators of consumer markets.

One approach would be for the government to set targets based on the Herfindahl-Hirschman Index (HHI) measure of industry concentration in some (but not all) markets. For example, in the personal current account market, the Government could explicitly task regulators with reducing the level of concentration to at least the level seen prior to the financial crisis. At present, the personal current account market is more concentrated than it was prior to the crisis, given the amount of consolidation that has taken place in the industry since 2008.

Whenever inflation is outside the Bank of England's target range of 2%, plus or minus one percentage point, the Governor of the Bank must write a letter to the Chancellor explaining why inflation is above or below target, and how the Bank proposes to respond to this. Similarly, under our proposed policy for industry concentration-targeting, whenever industry concentration in a consumer market is outside a certain target range, the relevant regulator would have to write a letter to a Government representative (such as our proposed Minister for Consumers, Competition and Markets) to explain why this is the case and the steps being taken to remedy the situation. We believe annual reporting, rather than monthly or quarterly reporting, would be most relevant in this instance, given the fact that industry concentration is unlikely to change significantly on a less than annual basis.

An appropriate timeframe would be given to reducing industry concentration to an appropriate range.

We discussed the notion of HHI targeting in a roundtable discussion with regulators, academics, civil servants and representatives from consumer groups. One concern expressed was the extent to which a measure of industry concentration is the best focus for government targeting. For example, it was noted that industry concentration is not in all circumstances a bad thing – such as when it allows higher levels of capital investment or where a market is concentrated-but-competitive (such as with groceries). Arguably, then, other metrics are more important such as industry profit margins and signs of "excessive" pricing.

We recognise these points but emphasise that, as with inflation targeting, regulators would not be expected to act if they feel immediate action is not required. For example, in a market such as groceries, which appears to be "concentrated but competitive", we would not expect any policy interventions to be triggered – provided that the government can be reassured on an ongoing basis that no harms to consumers are being experienced as a result of industry concentration. Indeed, in such a market, we would expect any HHI target range to have an appropriately high upper limit.

We anticipate significant complications associated with the government targeting profit margins or consumer prices – for example, due to the fact that profit margins can be manipulated by companies through various accounting practices, and due to the potential risks associated with politicising the pricing and profit margins of specific goods and services.

While industry concentration is not in itself always a problem (and may sometimes generate efficiency gains), we note that it is often *caused* by market imperfections – such as low consumer switching rates, informational advantages and barriers to scaling up for new entrants. As such, it is a useful "catch-all" indicator for gauging the health of some consumer markets. Placing a target on industry concentration, in some instances, would trigger new actions from regulators to tackle the negative causes of this concentration, such as low switching rates.

Along with data on industry concentration, we would expect regulators to regularly report to government on a range of consumer indicators, including trends in profit margins, switching rates and prices. This will help ensure that politicians are suitably informed about trends in consumer markets, and the outcomes faced by households.

Recommendation 6: Automatically switching sticky customers to challenger companies – broadening consumer markets and intensifying competition

A key driver of industry concentration and low levels of competition is the fact that customer switching rates are low across a range of key consumer markets. Data from Ofgem show that switching rates for electricity and gas both stood at 18% in 2017 – a low rate given the homogenous nature of electricity and gas and the fact that about six in ten households are on poor value standard variable tariffs (SVTs)[8]. The situation is even worse in the personal current account market, where only about 4.9 million current accounts have switched using the Current Account Switching Service since it was introduced in 2013[9]. This is a small proportion of the more than 65 million current accounts estimated to be open in the UK[10].

Low switching rates leave large incumbent companies with a significant pool of customers that are insensitive to price changes. Companies know that, even if they increase prices sharply and at a higher rate than competitors, they can expect a significant number of "sticky" customers to remain loyal to their services. Pressures to offer low and competitive prices across the board are therefore greatly diminished. This

[8] https://www.ofgem.gov.uk/publications-and-updates/ofgem-publishes-supplier-standard-variable-tariff-league-table
[9] Current Account Switch Service dashboard, issue 19 (published in July 2018)
[10] "Personal current accounts: market study update", CMA, July 2014

is perhaps most apparent in the energy market, where sticky customers find themselves on SVTs which are significantly more expensive than the best fixed tariffs on the market. In the current account market, given the "free banking" model, impacts on consumers are more subtle – though potentially include lower rates of interest on deposits and higher overdraft charges.

Government and regulators are of course aware of the key role of switching rates in determining levels of competition in consumer markets, and a range of initiatives have been introduced in recent years to try to increase switching rates. The focus of these initiatives has been on raising awareness of the ease and benefits of switching, as well as measures that aim to reduce any time, monetary and inconvenience costs associated with switching.

But these initiatives have not *dramatically* reshaped consumer markets, as evidenced by low switching rates and the significant proportion of consumers on poor value products. Ultimately, this suggests that a policy framework which focuses on encouraging consumers to switch, through better information and reduced barriers to switching, is unlikely to ever act as a game changer in reforming consumer markets. We need to be honest about the reality of consumers and the fact that nudging them to switch supplier will only have a modest impact on increasing competitive pressures in markets.

Faced with conflicting information, a lack of trust and high levels of uncertainty, consumers are often unlikely to switch supplier despite the potential financial benefits of doing so. This is often particularly the case with vulnerable and lower income households, with a growing body of research suggesting that poverty is associated with higher levels of risk aversion as well as constrained ability to make financial decisions[11], both of which undermine a household's propensity to switch providers for goods and services.

A much more radical approach to increasing competition in consumer markets is for regulators, the State or other non-profit entities to automatically switch customers that have not switched supplier for a number of years. For example, customers that have not switched energy tariff in the last three years could be automatically switched by Ofgem to an energy provider that offers lower tariffs than their current supplier.

Under such a policy regime, we propose that, at least initially, sticky customers in concentrated markets are only switched towards smaller "challenger" companies in markets. The rationale is that this has greater potential to reduce industry concentration in consumer markets – enabling new entrants offering good value propositions to greatly increase their market share. As we discussed in the previous chapter, one driver of high levels of industry concentration is barriers to scale, where companies struggle to gather a "critical mass" of customers from which their growth and expansion can gain momentum. This policy would help drive expansion of smaller companies by making it easier for them to acquire new customers – thus creating broader markets which are less concentrated.

[11] See for example, Behavioural Insights Team, *Poverty and decision-making – how behavioural science can improve opportunity in the UK* (2015); Sheehy-Skeffington and Rea, *How poverty affects people's decision-making processes* (2017); Anandi Mani et al, 'Poverty Impedes Cognitive Function', *Science*, 341 (2013)

Individuals that do not wish to participate in the automatic switching scheme would have the ability of opting out of the process, perhaps through notifying the relevant regulator using an online form or making a phone call. That is to say, the default under our proposed policy is that households are enrolled into the automatic switching scheme.

Ofgem is currently in the process of trialling a form of collective switching in the energy market, where "sticky" customers that have not switched supplier will be able to opt into a collective switch. Specifically, the trial offers a group of around 50,000 disengaged energy consumers the chance to have their energy savings calculated and an exclusive tariff, negotiated for them by an Ofgem-appointed consumer partner organisation. They will be able to take up the offer via the consumer partner's website or by phone. They will also be able to see a 'wide results' search, showing them the savings they could make with other tariffs across the market so they can make a fully informed decision[12].

Our proposed policy differs in two crucial ways to the Ofgem trial policy – and we believe it would be more effective in driving up levels of competition and improving consumer outcomes in the energy market. Firstly, as discussed, we propose that, at least for an initial period, individuals are collectively switched to challenger suppliers (i.e. companies that are not large incumbents). That is, the "Big Six" energy suppliers would not be able to participate in the collective switching scheme, at least initially. The rationale for doing this is that it would help broaden out and reduce industry concentration in consumer markets, which we believe would create more competitive and dynamic markets in the medium-to-long run. We envision the Big Six being allowed to participate in the collective switching scheme once industry concentration has reduced to a level agreed by the government and regulators.

The other area where we differ from Ofem's proposed policy is on whether individuals opt-in or opt-out of the scheme. As discussed, we propose that, by default, sticky customers are enrolled in the scheme and they have to choose to opt-out of it. In the Ofgem trial policy, by contrast, customers have to actively opt into the scheme.

Given low levels of customer engagement in the energy market at present, we have doubts about the extent to which such a policy can reach out to the most disengaged households.

An Ofgem trial carried out between 23rd November 2016 and 28th February 2017 saw sticky energy consumers, that had been on a variable tariff for more than three years, receive a best offer letter showing the savings they could realise from switching supplier. Over this time period, 12.1% of consumers switched, compared with 6.8% among a control group of sticky customers that did not receive the letter. While the letter had a significant impact on consumer switching rates, it is noteworthy that over 80% of sticky customers did not switch despite being shown the financial savings they could realise from doing so. In our view, this highlights the strong case for an opt-in default for a collective switching scheme.

An automated switching scheme needs to have safeguards in place, and we would caution against an approach that focuses on price alone. For example, we would expect

[12] https://www.ofgem.gov.uk/publications-and-updates/overview-our-collective-switch-trial-february-2018

the regulator or other body overseeing the automatic switching process to take account of factors such as customer service provision, the ability of challenger companies to provide good service to a much greater number of customers and the underlying financial resilience of companies' business models. Recent failures of smaller energy suppliers, such as Future Energy which ceased trading in early 2018, highlight the need to ensure financial durability among energy suppliers, or at the very least assure consumers that a company failure will not result in their electricity or gas supply being cut off.

While a policy of automated switching perhaps lends itself most readily to the energy market – given the homogenous nature of the products being purchased by households (electricity and gas) – we could envision it being rolled out elsewhere. For example, while automated switching might not be appropriate in markets such as broadband and pay-TV, given that choice of product is dictated by a range of factors beyond price (such as broadband speed and TV content) – we could envision automated switches being applied to customers on fixed-line only phone contracts. Ofcom analysis suggests that those on fixed-line only contracts are particularly likely to be older, on low incomes and disengaged from the telecoms market[13].

Automated switching would be difficult to introduce in the personal current account market. The appropriate choice of bank for a customer is determined by a wide range of factors, including:

- Introductory offers (signing-on bonuses) for those that switch current account
- Levels of interest being offered on deposits
- Overdraft charges
- Ability to access deals for other products
- Protection of savings held with a bank – the Financial Services Compensation Scheme currently guarantees savings up to £85,000. For those with savings in excess of this, a greater weight may be placed on the underlying governance and financial stability of a bank
- Income restrictions associated with some personal current account products, which require a certain sum of money to be deposited each month
- Access to physical branches

Given the challenges of rolling out automated switching in the personal current account market, our recommendation is that concentration in this consumer market is best addressed through other means – such as use of data, apps and other new technologies which we discussed earlier.

While automated switching to challenger brands may not be a suitable policy intervention in all consumer markets, we believe it could provide a significant boost to competition in some circumstances. It should be explored as an approach to tackling high levels of industry concentration in relatively homogenous consumer markets – namely energy and fixed line-only telecoms – where there is a significant body of evidence to suggest that a lack of competitiveness and low switching rates are leading to poor consumer outcomes. Such evidence would include, but not be limited to:

[13] Ofcom (February 2017), "The review of the market for standalone landline telephone services"

- Profit margins which are deemed to be excessive, or which have increased over time.
- Poor customer service.
- A significant proportion of consumers on relatively bad value products (such as standard variable rate energy tariffs) compared with better value products (such as fixed energy tariffs)

Recommendation 7: "Click in, click out" – ending the asymmetry between subscribing and unsubscribing.

Regulators have made strides in reducing the frictions – time, money and inconvenience – associated with leaving a company and switching supplier. But there is still scope to go further.

One friction to leaving a company that we would like to see eliminated is the asymmetry that companies place between subscribing and unsubscribing from services.

For example, while it may be possible to subscribe to a broadband package or pay TV on the internet, unsubscribing often requires an individual to make a telephone call to the company. This is a deliberate attempt by companies to make it harder to walk away from a service. A phone call is often more onerous than an internet-based cancellation, and hard selling techniques are often applied to prevent a customer from leaving a company. Furthermore, lengthy hold times before speaking to someone, and limited call centre opening hours create additional frictions compared with internet-based cancellations.

We would like to see this asymmetry removed from consumer markets. One simple way of doing this is for the government and regulators to require companies to have a symmetric approach to subscription and unsubscription – if it is possible to sign-up online to a product, such as a pay-TV or broadband service, it should be possible to unsubscribe online.

Creating symmetric consumer markets, in terms of ease of subscription and unsubscription, would support competition, driving up service quality and value for money. Making it easier for consumers to abandon a product will place extra pressure on companies to retain their customers. At present, many companies deliberately make it much easier for consumers to acquire a service than to walk away from it, often using "teaser rates" to draw customers in. This practice needs to be curtailed.

CHAPTER 4: CONCLUDING REMARKS

Consumer markets play a key role in driving up living standards and improving our quality of life. As a result of the competitive pressures created by markets, we have more access to a diverse range of products and services than ever before. Technological innovation has also drastically improved day-to-day convenience – for example with online banking and retail.

But we need to acknowledge that our market-oriented economy is not without its flaws. Critically, some of our most important consumer markets – banking, energy and telecoms – fall far short of the economic ideal of perfect competition. Concentration in these industries is high, with markets dominated by a small number of large players. Furthermore, competitive pressures to keep prices low and improve customer service are often relatively weak, in particular due to low customer switching rates.

In some cases, companies deliberately create hurdles to walking away from their services, while at the same time making it very easy to sign up to their products – for example, being able to sign up online, but requiring a telephone discussion to cancel a service.

Lack of competitive pressure, and the high prices and poor customer service associated with it, are undermining consumer faith in a market-oriented economy. A YouGov survey in 2017 showed over half of individuals in the UK (53%) believing that the energy market should be nationalised, while about three in ten felt the same way about the telecoms market (30%) and banking industry (28%)[14]. In the water and rail industries, which are currently run as a series of privatised local monopolies, about six in ten consumers were in favour of nationalisation.

Proponents of markets need to recognise the shortcomings that are driving discontent. Rather than criticising the nationalisations and big government approaches being proposed by some, market proponents need to start focusing more on offering compelling solutions to the inadequacies of some of our consumer markets.

In this report, we have presented a range of potential policy solutions which we believe would go some way to restoring faith in markets by generating increased levels of competition. This in turn should drive down consumer prices and encourage innovations and improvements to customer service. We hope that these recommendations drive more debate around issues of concentration and competition in markets, and encourage policymakers to adopt bolder approaches to tackling some of the problems currently faced in markets.

[14] https://yougov.co.uk/news/2017/05/19/nationalisation-vs-privatisation-public-view/