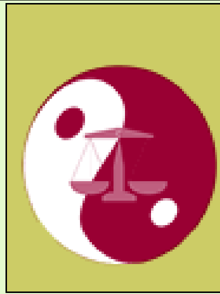

# Submission on Productivity Commission's Draft Report - Review of Australia's Consumer Policy Framework

by

## Foundation for Effective Markets and Governance

January 2008

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This submission has been prepared by the Foundation for Effective Markets and Governance (the Foundation) in conjunction with Mr Ian McAuley who has drafted most of the economic content.

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The Foundation provides advice in the development, implementation and administration of economic regulation (including competition and consumer law) and in capacity building for civil society. It is based at the Australian National University.

It comprises experts from three main streams:

- former Commissioners and staff of Australian Competition and Consumer Commission (ACCC);
- people with a background in the consumer movement, governance and civil society; and
- academics with a special interest in competition, consumer and regulatory law and its administration.

This submission covers three elements:

- Comments on Draft Report Recommendations;
- Issues that the Draft Report does not fully address;
- Other comments

## 1. Comments on Recommendations

**Draft recommendation 4.2 – exemption from misleading or deceptive conduct provisions**

We would not support an exemption for due diligence areas and propose that the ACCC and the Australian Securities and Investments Commission have joint jurisdiction over market conduct consumer protection laws.

**Draft recommendation 4.4 – Australian Governments to consider the introduction of a single national regulator**

The cost benefit analysis suggests considerable benefit to the community through the adoption of the policy package. This recommendation together with that of enacting generic law seem to be key recommendations of the package. However, we have some reservations about the proposed national regulator. While it may be manageable in terms of Part V (of the Trade Practices Act) issues there are many other consumer protection issues handled by States and Territories. Also if the national regulator were the ACCC it already has a broad range of responsibilities and there would be the risk of competition and consumer protection regulation being swamped by these other roles. In addition, there is the issue of the large volume of consumer complaints currently received at the State/Territory level. We have concerns that unless these issues are adequately addressed there may be no net benefit to consumers.

**Draft recommendation 6.1 – portfolio linkages between consumer and competition policy**

Subject to our comments above we are strongly of the view that there are advantages in a national regulator having competition and consumer protection responsibilities.

**Draft recommendation 7.1 – 'safe harbour' contracts**

We believe there should be provision for the regulator to remove this protection in the case of misrepresentation or material change in circumstances.

**Draft recommendation 8.2 product recalls and bans**

Consideration should be given to preventing importers, manufactures, etc from re-exporting unsafe or dangerous goods to developing countries and to preventing any such goods in transit from being redirected to developing countries.

**Draft recommendation 9.3 – use of written submission in small claims Tribunals**

We take the view that parties should have the option of relying on written submissions and that the power to disallow that option (provided a copy of any submission is made available to the other party) should rest with the Tribunal, on objective grounds, and not the other party.

## 2. Issues not fully addressed

This part of the submission is concerned with what the Commission has largely overlooked in its inquiry.

Although its main concern was the "framework", the Commission has interpreted this term widely, for example in recommending lifting price caps on utilities and on expanding unfair contract provisions.

Among consumer policy issues which the Commission could cover in more depth are:

1. *price discrimination*, resulting in transfers between consumers, which may (or may not) result in detriment to those who are already disadvantaged;
2. *consumer issues in health and education*;
3. *structurally corrupt markets*[1]**,** particularly where intermediaries such as financial "planners" have an incentive to oversell;
4. *bundling of unrelated products*, such as supermarket purchases/gasoline, credit cards/frequent flyer points;
5. *producer exploitation of consumer biases*, such as anchor point pricing, manipulating consumers' inability to appraise risk;
6. *the net benefits or costs of expanded competition*, particularly in utilities;

While the Commission could at least make mention of these issues, some, such as price discrimination, bundling and utility competition, would require significant research, which could be incorporated into the Commission's work plan.

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1. A term coined by Louise Sylvan in her time at the ACA.

This part of the submission covers these six points.

### 2.1. Price discrimination

It is informative to contrast two points made on the same page.

- Most Australian markets are much more competitive than in the past.

  and

- Around 80 per cent of household income is now spent on services (Vol 1, p6).

These points are indisputable. But the unstated chain of reasoning that flows from the first point – that more competition leads to undisputed consumer benefits – is questionable.

The conventional economic model is of a market with one price for each good on offer, and in the competitive market that price equates to firms' marginal cost of production. It's a neat theory, which tends to hold in many markets, particularly goods markets. Most of us don't shop around, but we trust that market prices are kept in check because of the work of "market perfecting agents" from whom we all enjoy an external benefit.

But services generally involve close one-on-one consumer-provider transactions, and often involve some degree of customization. There is no one price for house modifications, tailored holidays or superannuation. And that's where the growth is – we are moving away from the economists' model.

Even where products are reasonably homogeneous, in many markets there is a tendency toward individualization of prices – "first degree" price discrimination in economists' terms. For example:

- air travel, in which a huge variety of fares exist for the same service, and in which minor variations in service (e.g. economy vs business class) can be used to charge vastly different prices;
- utilities, where potential new customers are made offers not available (or at least not notified) to existing customers;
- gasoline prices, where the savvy and those with time on their hands fill up on days of low prices, while others pay higher prices. (The recent ACCC inquiry on gasoline failed to see that what was in operation was essentially price discrimination.)

This is not to suggest airlines, utilities or gasoline firms are systematically ripping off consumers. Competition policy may be keeping their overall prices in check. But they are cross-subsidizing some consumers; some are paying more than others. The policy question is whether these cross-subsidies are fair. Are they falling on the vulnerable or disadvantaged?

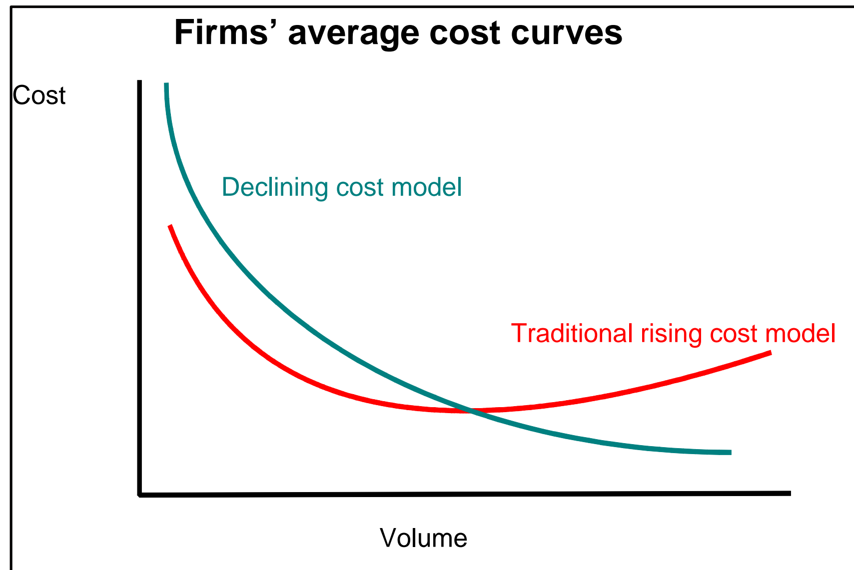
Neither is this to suggest that price discrimination is categorically undesirable. In industries where firms have high fixed costs and low variable costs price discrimination can be a means of ensuring an economically efficient allocation of resources. We accept price discrimination in many "bums on seats" industries; we don't object when our discounted economy class fare is subsidized by the first class traveler up front, or when we enjoy cheap admission to the cinema on a selected evening. But, because of its equity implications, it needs to be covered.

Because of tremendous improvements in production technologies over the last 50 years many more industries are now fitting the high fixed cost/low variable cost model.  CDs and air travel come readily to mind. Similarly the manufacture of cars and household appliances, once made in labor-intensive ways, is now an operation with massive scale economies.

The Commission, in its assessment "how are consumer markets changing" seems to ignore the tendency for the shape of firms' cost curves to change, and nowhere in the Report is there even acknowledgement of price discrimination, even though, until recently, price discrimination was within the ambit of the ACCC.

This is not to suggest economists are ignorant about the phenomenon of industries moving to high fixed cost/low variable cost means, but economists tend to treat such industries as exceptions to the more general rule, rather than a mainstream development – in part because they do not fit the simple competitive model which predicts an equilibrium of a single price at marginal cost.  Rather, pricing in such industries is a strategic[2] exercise, often involving complex price discrimination.

Price discrimination is also becoming easier thanks to developments in marketing which individualize prices – under the general term "customer relationship management". If I am shopping on line I am not necessarily in an emporium with posted prices. The retailer may have learned a great deal about my willingness to pay, and may have tailored offerings just for me.  Firms send me special offers, financial advisers know the product "just made for me", and "just priced for me".




Another form of price discrimination relates to redress.  The Commission is correct in pointing out that for the vast majority of cases conflicts are settled by direct negotiations between firms and customers.  In most cases these are probably in good faith, and if firms notice a pattern of complaints they will modify their offerings.  But firms may use such rapid redress as a means of discrimination.  For example consumer groups find that customers who complain about unreasonable bank fees usually obtain speedy individual rectification, while others suffer in silence.

2. In the traditional sense of "strategic" as spelled by Schelling, rather than the buzz-word of managementspeak.

Whether price discrimination is fair or unfair is not an easily settled question. In terms of our normal notions of equity, it is probable that:

- it is fair when there are transfers from those with a high capacity to pay to those with low capacity to pay – e.g. first class to economy class fares;
- it is generally fair when there are transfers from those with a high opportunity cost of time to those with a low opportunity cost of time – i.e. from busy people to people with time to shop around;
- it is generally unfair when there are transfers from the uninformed to the informed, or from the impatient to the patient – e.g. from those who buy products with "shrouded attributes";
- it is unfair when it is based on purchasing power – e.g. deep discounts on cars and accommodation offered to corporate customers, cross-subsidized by individual consumers;
- it raises difficult questions when those who are frequently switching to low-prices are benefiting at the expense of more stable customers, for switching, in itself, imposes some costs on suppliers. In more colloquial terms hyperactive consumers are nuisances, whose hyperactivity imposes costs which are passed on to other consumers. In this regard policies which encourage switching, such as operate in the UK, may do no more than re-shuffle surplus between consumers, while imposing transaction costs on all.

### 2.2. Health and education

While production technologies, exploitation of scale economies, and competition have made many goods much cheaper, there are significant exceptions in intrinsically labor-intensive industries, such as health and education.

The importance of health and education is touched on in Figure 1.1, which, tellingly, shows health and education to be below the waterline of consumer policy. Consumer authorities tend to see them as falling outside their ambit. This is a general shortcoming of administrative arrangements which compartmentalize "consumer" issues. In many goods markets the hedonic qualities of what is available to rich and poor are converging,[3] but this does not necessarily hold for health and education.

Is it a misallocation of administrative resources to have consumer regulation focused almost exclusively on areas where competition and technology have already brought significant benefits? Should not the ACCC, for example, be paying more attention to the denial of access to high quality education which occurs when there is a "flight of the elites" to private schools. In health and education expansion of "choice" to those with means often results in restriction of choice to those without means.

### 2.3. Structurally corrupt markets

To say a market is "structurally corrupt" is not to suggest there are illegal or underhand practices. Rather, it is about the corruption of the assumed economic model in which suppliers' objectives are to do with profit maximization. When there are intermediaries (including employees) who have incentives other than profit maximization, often maximization of sales, the market can be said to be structurally corrupt.

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3. "The new (improved) Gilded Age" *The Economist* Dec 22 2007.

The Commission correctly identifies regulation of mortgage brokers as a problem, but only in terms of jurisdictional integration.

Mortgage brokers are just one example of a set of sales intermediaries whose remuneration relies not so much on the profitability of their transactions, but on the volume and value of their transactions. The intermediaries have an inbuilt incentive to oversell.

One may believe that suppliers themselves would prefer profit to sales and not provide such incentives to their agents; after all the economists' "model of the firm" suggests that firms are motivated by profit rather than growth. But business theorists and institutional economists often identify other corporate objectives, particularly growth (either absolute or market share).

If they are to make wise choices consumers need to be aware of the incentives applying to sellers, and to understand the principal/agency relationships involved. It may be naive for consumers to expect "free" advice, but terms such as "financial advisor" rather than "commission agent for AMP/AXA/etc " tend to mislead.

Therefore a minimum requirement could be a "truth in labeling", so that use of terms such as "financial planner" is prohibited for all except those who operate on a fee-for-service basis, and for those who operate on sales commission to be clearly described in their business correspondence and advertisements as "commission agents".

A further information refinement could be to require those working on commission to reveal to consumers not only the percentage commission, but also the net present value of the expected cash flows to the agent (e.g. based on assumptions of ten years and a discount rate equal to the real bond rate). A more stringent requirement in the case of investment products could be to reveal the future value of the cost of deducted commissions and charges, as is done in certain independent calculators of superannuation benefits.

### 2.4. Bundling of unrelated products

The Commission mentions bundling in the context of complexity, but has little to say about its desirability or otherwise. And the closely related phenomenon of third line forcing is not mentioned.

Bundling can have consumer benefits when it reduces transaction costs on related products – a point acknowledged by the Commission. Electricity and water bundling may have benefits if it involves economies in billing, metering and checking credit references.

But when it comes to unrelated products, the evidence points to high transaction costs, as credit card companies have to deal with airlines, for example, or when consumers have to collect supermarket receipts to buy gasoline and when filling stations have to record the discounted transactions. An extreme instance of bundling occurs in nursing homes, where in some cases, once a consumer has exercised choice (a choice often constrained by short supply), there is little further choice of bundled services.

Bundling of unrelated products has three effects besides transaction costs:

- it leads to many consumers having to pay for goods they do not want. (Contrary to the belief of airline executives, there are many people whose desire to fly is on a par with their desire to be herded into a cattle truck);

- it locks consumers into particular suppliers – “loyalty” is the euphemism for this constraint on competition;
- it leads to costly disputes, such as when airlines change their points rules. Rather than dealing with such problems through unfair contract provisions, unrelated bundling should be generally prohibited as a restraint on competition.

**2.5. Producer exploitation of consumer biases**

The Commission was obliged to consider empirical evidence in its terms of reference:

> the need for consumer policy to be based on evidence from the operation of consumer product markets, including the behaviour of market participants

The Report has a section on behavioral economics, but it tends to be dismissive of any policy prescriptions based on behavioral findings. The Commission’s reasoning is that most findings of behavioral economics are based on laboratory studies rather than field observations. (By contrast, conventional economics is based on an axiomatic faith, but that has never given economists a great deal of trouble.) And it suggests that we tend to overcome our behavioral biases over time and when significant amounts are involved in our transactions.

Therefore apart from reference to considering behavioral responses to disclosure (Vol 1 p. 47) the document is light on behavioral policy responses.

This is in spite of evidence of poor decision-making as a result of behavioral biases. The report notes that many consumers are unaware of the implied warranty provisions of the TPA, and therefore buy unnecessary protection cover. Behaviorally such over-insurance may result not from ignorance but, rather, from behavioral biases (vividness, hypersensitivity to loss). In the Report’s section on behavioral economics and public policy there is reference to irrational over-insurance (Vol 2 p. 313), the influence of “shrouded attributes” (Vol 2 p. 313), suboptimal risk appraisal (Vol 2 p. 355). It reports on four biases (overconfidence, endowment effect, choice overload and present bias) that may have “particular policy interest” (Vol 2 p. 320), but does not develop these. (In the process it overlooks the massive policy interventions of mandated superannuation and heavily subsidized private health insurance, which clearly have a behavioral origin.)

Debates on empirical sciences are always subject to their own confirmation bias. Apart from the pure academic theoretician (perhaps an extinct species), advocates are prone to fall victim to confirmatory biases. It would be surprising if the Commission staff provide an exception to this rule.[4]

The behavioral issue missing in this report is the extent to which regulators should intervene in the practices of marketers, particularly advertisers. There is an acceptance that “bait” advertising should be proscribed, but there are many other advertising practices designed to lead consumers away from welfare-improving decisions, such as:

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4. We note the Commission does not include the confirmation bias in their section on behavioral economics.

- frames around anchor points – “normally $200, now just $179”.[5]
- exploitation of utility curves – the cashback offer is attractive because it is seen as a “gift”. “$1000 with $100 cashback” is much more attractive than “$900”.
- exploitation of the present bias – teaser offers, “nothing to pay for 6 months”.
- vividness – use of fearful images in selling insurance.

It may be difficult for the Commission to make categorical recommendations on marketing practices which exploit consumer biases. That is a major topic in its own right. But it warrants mention, and inclusion in the Commission’s work program.

**2.6. The costs of expanded competition**

The section on utility services goes into great detail about the desirability of switching (a counter-argument is presented earlier in this document) and of protecting vulnerable and disadvantaged consumers through specific measures (rather than use of price caps).

Yet, the Commission seems to have overlooked the fact that there has never been any *ex post* analysis of the net benefits of utility privatization and separation of contestable elements. The table below lists the elements that should be considered.

| Benefits | Qualifications | Costs |
|---|---|---|
| Competition for service – e.g. faster phone connections | Not applicable to water or electricity | Ignoring marginal consumers – e.g. rural consumers |
| Technical efficiency, less featherbedding | Industries are capital intensive with little opportunity to shed labor costs | Higher managerial salaries |
| Better capacity utilization | | Under-investment in peak capacity |
| Arm’s length from political interference | But still scope for corruption in appointment of regulatory boards | Loss of democratic control |
| Consumer choice | Only in the case of telecoms is there some differentiation, otherwise same product delivered | Consumers’ search and switching costs, aggravated by “confusopoly” |
| Nil | | Extra marketing costs – promotion, billing, keeping records of bad customers |
| Nil | | Higher private sector costs of capital, including sovereign risk |

5. A retail manager explained to us that most “Manchester” (sheets, towels etc) sales are made in post-Christmas and end of financial year promotions. Full price sales are the exception. Have we ever seen an advertisement for bed sheets “normally $60, now $139”?

| Nil | | Underwriting/legal costs at time of disaggregation and privatization |
|---|---|---|
| Nil | | Regulatory costs in natural monopolies (regulatory agencies and firms in complying with regulations) |
| Nil | | Transaction costs between firms in disaggregated supply chains (e.g. generators to distributors). |

As pointed out in the Report, we now have a great variety of goods and services, which "has increased the investment required to compare alternatives".

We therefore allocate our scarce shopping time to those markets where there is choice and innovation – clothing, food, recreation etc.

But water and electricity? There is no choice. Whoever "sells" them, they are the very same fungible commodities. Our only "choice" relates to who sends the bill. That's choice without variety. In essence, competition policy in utilities has meant insertion of a salesperson between producer and consumer where none was required before – an expensive form of makework.

One of the findings in relation to markets is "greater reliance by consumers on skilled intermediaries". But, implicitly, the Commission rules out even considering our use of the government as the "skilled intermediary" to provide water and electricity at reasonable prices, so we can allocate our scarce shopping time to something useful. And why has no public agency conducted the benefit-cost analysis suggested in the table above?

Is there a hint of untested ideology in the Commission's statement that effective market competition is the most important safeguard for consumers? (Vol 1 p. 2).

It would be useful for the Commission to undertake an *ex post* analysis of one industry in one region, such as electricity in one major state, comparing the costs and benefits identified above, against the standard of a technically efficient government-owned vertically integrated monopoly.

## 3. Other comments

This section of the submission covers some other issues which require clarification or correction in the Report.

### 3.1. Abolition of price caps

The Commission favours market solutions, but it avoids making any recommendations on metering for utilities. Complex mechanical water and electricity meters are all but illegible to consumers, and much better metering technology has been available for many years.

But Victoria seems to be the only state where this is a concern. (Vol 2 p. 421). Utility pricing without transparency in pricing is a basic violation of economic principles. We insist on price tagging in supermarkets; why should utilities be exempt?

### 3.2. Inadequate benefit-cost analysis

There is a box which suggests as a design and implementation principle the consumer policy framework should:

> facilitate soundly-based intervention by: focusing on addressing material shortcomings in market outcomes at the lowest possible cost to business and regulators, and with minimum risk of unintended or perverse consequences. (Vol 1 p. 14)

That's hardly a basis for a benefit-cost approach, for it considers only costs faced by businesses and regulators, without considering costs borne by other parties, particularly consumers.

Possibly that's no more than poor drafting, for the Commission's other sections on benefit-cost analysis are more inclusive.

One further point in relation to cost/benefit. The Report generally seems to recognize costs borne by business through consumer protection law but does not recognise that there are also benefits to business. For instance, businesses not having to compete with other business that compete 'unfairly'. Businesses have the right to seek damages, etc against other businesses that have contravened the law and caused damage to their business. There is also consequential goodwill accruing to businesses that are seen by consumers to be responsive to consumer issues.

### 3.3. Tariff reform

There is the statement:

> In recent years, many reforms of major benefit to consumers have occurred without extensive input from advocacy groups. Tariff reform is a case in point. (Vol 1 p. 48)

In the 1980s the ACA was very active in tariff reform, particularly in the major cases of textile, clothing, footwear and motor vehicles. But we also know that at least one person appearing before the Commission has suggested that consumer groups have not supported competitive reform.

### 3.4. Overseas transactions

This is a neglected point. In Australia we are fairly local in our consumer transactions. Our personal transactions outside the protective umbrella of Australian policy are limited to tourist traps (including car rental), and some internet transactions. But in other countries consumers are exposed to huge foreign transactions. British people have been buying real estate in Spain and Portugal, and are now investing large sums in the United Arab Emirates. Canadians are retiring to southern US states. USA citizens are buying property in Panama

Apart from providing warnings, there is not a great deal our policymakers can do. But the issue warrants a mention.

### 3.5. Custodial penalties

There is no mention in Recommendation 10.1 or in supporting argument of the possibility of custodial penalties, even though it is stated policy of our present government. Who eventually pays civil (or criminal) financial penalties? Although competitive theory suggests these are borne by shareholders, surely some of these come back to the consumer in some form, particularly in markets where price-rigging is widespread. It takes a great deal of faith in the conventional economic model to

overlook the possibility that fines are ultimately passed through to consumers. Only when collusion occurs in one small segment of a market can we be confident that costs of fines will be borne by business stakeholders, and even then some significant costs will be borne by the innocent, such as junior employees.

### 3.6. Financial literacy

The Report mentions the Financial Literacy Taskforce, but points out the need for general skills:

> One role of governments is to encourage the development of basic skills — such as by supporting literacy or personal capability through education and other social programs. These policies can help empower consumers, but they are beyond the ambit of this inquiry. (Vol 2 p. 213)

It's a strong point – probably about as strong as the Commission can make without a broader reference. The Financial Literacy Taskforce has avoided issues which would have been embarrassing to the previous Government, particularly the distinction between real and nominal interest rates (which the former Treasurer ignored, for it would have undermined his political interest rate comparisons). The Commission has a neat explanation of this point, buried towards the back. (Vol 2 pp. 387–388).

We need far better financial literacy education, unhampered by a government fearful of an informed electorate.

### 3.7. When is industry-specific regulation most appropriate (Box 5)

Almost every industry can argue some aspects of its operations are unique and are of such a technical nature that they require special consideration. These issues should generally be addressed, for instance, by appointment of appropriate expertise to the national regulator and in any case any specific regulation should be subject to review after a reasonable time.