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Global Forum on Competition

**HIGH SWITCHING COSTS: A BARRIER TO COMPETITION
AND A DETRIMENT TO CONSUMERS**

Contribution by Mr. Mark Williams

-- Session VI --

This contribution is submitted by Mr. Mark Williams (Director, European Competition Policy, NERA Economic Consulting) under session VI of the Global Forum on Competition to be held on 21 and 22 February 2008.

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Do switching costs really make markets less competitive?



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How Markets WorkSM

Outline



1. Types of Switching Costs
2. Stylised Facts of Utilities Markets
3. Do Switching Costs Matter?
4. Competition with Switching Costs:
Foremarkets and Aftermarkets
5. "Prefunding"

1. Types of Switching Costs



- Switching costs take many forms and arise in a wide variety of markets:
 1. Transaction Costs (Banks)
 2. Compatibility (Video Games)
 3. Learning Costs (Equipment)
 4. Contractual Costs (Frequent Flyer)
 5. Trust Costs (Professional Services)
 6. Search Costs (Restaurants)
 7. Time and Hassle Costs (Utilities)
 8. Inertia / Irrationality (Most Cases)
- Switching costs are not unique to utility markets

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2. Stylised Facts about Utility Markets



- The “stylised facts” of utility markets would seem to be:
 1. A significant fraction of customers almost never seem to switch
 2. Those that do switch do not always switch sensibly, viewed either *ex ante* or *ex post*
 3. Incumbents can hold on to significant market share despite the presence of (many) competitors

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3. Do Switching Costs Matter? - 1/3



- There is an instinctive reaction that the presence of switching costs implies a competition problem. However:
 1. Critical Loss and Marginal Customers
 - In standard competition policy cases, the key question is not whether all customers would switch (in the event of a price rise) but whether sufficiently many marginal customers would switch, and whether the sales to such customers are above the critical loss value
 - e.g. with $MC=0$, a price rise of 10% is unprofitable if 11% of sales are lost in response. So if switching costs imply that 89% of sales are to customers that will not switch, there is no competition problem
 - Observation: in a market characterised by a legacy incumbent monopolist and a highly competitive entrant sector exhibiting low margins, an incumbent strategy of “milking” the installed base is often more profitable than responding to competition

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3. Do Switching Costs Matter? - 2/3



2. Switching Costs are (often) real economic costs
 - Many forms of switching costs are real economic costs
 - Like any costs, it is desirable that they be minimised by avoiding the activity (switching) that causes them
 - Economically there can be “excess switching”
 - Remark: switching to a higher-priced supplier is particularly harmful:
 - First, the switching cost is incurred with no improvement to allocative efficiency
 - Second, the “competition externality” (that switching forces firms to set competitive prices) is potentially undermined
 - An understanding of how effectively customers switch is important

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3. Do Switching Costs Matter? - 3/3



- 3. Switching costs do not necessarily reduce competition as opposed to change the nature of competition
 - Switching costs may reduce competition “in the market”
 - However, if customers are sticky once acquired, this tends to push competition back one step up the supply chain: the profits that can be obtained precisely because of switching costs potentially intensify competition “for the market”
 - Observation:
 - In many markets with switching costs (mobile phones, video games) *ex ante* competition for the market can be vigorous
 - In legacy, long-dated incumbent monopolist markets, this will less likely be so (absent a technological revolution)
 - **Conclusion: hasty conclusions that switching costs imply insufficient switching and/or inadequate competition are not necessarily correct**

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4. Competition with Switching Costs: Foremarkets and Aftermarkets



- Foremarkets and Aftermarkets
- Consumers purchase some product in all periods
- Essential competition policy problem:
 1. *Ex ante*: market is (typically) competitive
 2. *Ex post*: market is (apparently) monopolised because of switching costs
- Policy puzzles:

	Ordinary Market	Switching Costs
1. Low Prices	Predation	“Prefunding”
2. High Prices	Excessive Pricing	Aftermarket and foremarket return normal

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5. Prefunding - 1/3



- If *ex post*, firm can exploit lock-in to extract an amount M , *ex ante* competition will discount the foremarket price by M compared to the normal level
- Key Result: the *ex post* rip-off is prefunded
- There is no overall rip-off provided the *ex ante* market is competitive
- Two issues arise:
 1. The Structure of Prices
 2. Limits to Prefunding

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5. Prefunding - 2/3



- The Structure of Prices:
 - Consider a standard monopolist. We know that there is:
 - a. a profit rectangle – the extracted profit, and
 - b. the welfare triangle – the deadweight loss due to output restriction
 - So low foremarket and high aftermarket prices can lead to the wrong structure of prices
 - Calls to Mobile
 - Consumer make too few mobile calls
 - Consumers change handset for an upgrade “too often”

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5. Prefunding - 3/3



- Are *ex post* rents fully dissipated in the foremarket?
 1. If aftermarket profit is uncertain, what level will be prefunded?
 - risk-neutral firms with no capital constraints prefund the expected value
 - with risk-aversion or imperfect capital markets, rents remain
 2. If switching costs differ between buyers:
 - if prefund average, and buyers know their "type", adverse selection
 - so firms will prefund lowest *ex post* aftermarket profit
 3. Non-negativity of the foremarket price
 4. Market power may exist in the *ex ante* market (e.g. in legacy utility markets)
 5. Profit Rectangles can be prefunded; welfare triangles cannot

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