Fairness in Pricing

FIRMS NEED TO BE ON TOP OF AN ISSUE THAT IS RISING FAST UP THE POLITICAL AGENDA

Regulatory debates in 2018 put greater emphasis on "fairness" rather than "markets working well". Easier to espouse than to define, fairness looks set to be one of the main drivers of regulatory activity this year, too. With the Competition and Markets Authority talking tough in its recent work on loyalty pricing, firms should expect to come under even greater scrutiny and be ready to explain and defend their current pricing models in the political and public spheres. Beyond technical submissions to regulators, this will require honest self-assessment and a good communications strategy.

Putting the fairness debate in context

"Fairness" has become the new favourite demand for politicians of all stripes in the UK. After all, it sounds like something most people would want. Not even politicians hostile to redistribution run for office advocating "unfairness".

- The last Conservative party election manifesto called for a "stronger, fairer, more prosperous Britain", with one focal point being "fair markets for consumers". Conservative policies include "strengthening the hand of regulators" and putting "the interest of vulnerable consumers first, including considering a duty on regulators to weigh up their needs".
- The manifesto of the main opposition Labour party demanded a "better, fairer Britain" and included policies such as expanding the role of the Groceries Code Adjudicator to ensure "suppliers and consumers get a fair deal."
- The Scottish National Party, the main party in the Edinburgh parliament, is introducing a Consumer Protection Bill "to secure fairer outcomes for customers".
- The Liberal Democrats, the fourth party in the House of Commons, the lower house of the UK parliament, aim to create "an economy that works for the long term: prosperous, green, open and fair".

While fairness is a natural theme for politicians, regulators have struggled to flesh it out in practice. No wonder. Fairness is an elusive concept. Everyone has a different view of what constitutes a just outcome, which is why they find it difficult to rank various policy options according to their fairness. Judging the merits of trade-offs involved in a pricing scheme, for instance, is a complex task even for experts. Remember, one person's loyalty penalty is another's introductory discount (and vice versa).

Against this backdrop, a clutch of regulators have swung into action. The first was Ofgem, which was required by legislation to impose a cap on energy prices. Lawmakers mandated the cap – while leaving it to Ofgem to work out the details - because of concerns about an "energy market that punishes loyalty with higher prices". When it announced details of the cap, which took effect on January 1, the energy regulator emphasised how it would give 11 million people in the UK "a fairer deal".

Other UK regulators have started to follow Ofgem's lead. Last October the Financial Conduct Authority (FCA) published a Discussion Paper on the fairness of certain pricing practices in financial services, marking the start of a public debate that the regulator is keen to have. The initial round of the debate, which closed recently, focused on two issues: 1) price discrimination, when firms charge different customers different prices based solely on variations in their price sensitivity; and 2) loyalty pricing, when firms charge existing customers more than new customers.

The practice of imposing loyalty penalties in five "essential" markets was the subject of a high-profile "supercomplaint" lodged by Citizens Advice, a network of independent charities providing advice to UK consumers on a range of issues. (The supercomplaint is a mechanism by which a small number of nominated organisations can raise issues with UK regulators.) In a firm response just before Christmas, the CMA endorsed the supercomplaint and recommended using enforcement and regulatory powers to clamp down on harmful practices. To read more, please click here. The CMA's strong words bore the hallmark of its new chairman, former MP Andrew Tyrie, who upon his appointment last summer called for more powers to help the regulator better protect vulnerable customers.

The UK's communications regulator, Ofcom, recently wrapped up a consultation on helping consumers to obtain better deals. It is also examining the scale of any harm resulting from pricing practices in the fixed broadband market. The two initiatives build on an earlier consultation aimed at helping consumers to get better value for money on mobile handsets.

Fairly efficient

The competition and welfare economics frameworks that underpin nearly all modern regulation focus on economic efficiency: how can lawmakers and regulators maximise total welfare now and in future? These frameworks are not geared towards making judgments about the desirability of one outcome over another – not least because of the difficulty of establishing a universal standard for fairness, as discussed earlier. Nevertheless, in practice, regulatory processes recognise the importance of distributional outcomes and pay a good deal of attention to them.[1]

In those cases where there is no clearly definable positive outcome, regulators have tended to leave matters to market forces. When they intervene, their purpose has been to give consumers maximum information so they can make informed choices. Typical interventions have included mandatory renewal notices, attempts to improve disclosure at the point of purchase, and various mechanisms aimed at helping customers shop around based on price (and sometimes on quality). For example, insurers are now obliged to include in general insurance renewal notices a reminder of the previous year's premium, while banks must publicise in their branches and on their websites the results of current account and small-business banking quality surveys.

The latest developments are an attempt to look at fairness more directly. But they should be viewed as an evolution, not a revolution: the well-known economics underlying fairness have not changed.

The financial services experience

The FCA has been particularly prolific in publishing a number of papers on fairness over the past 12 months, culminating in a new framework for assessing fairness in price discrimination.

The framework has six elements, as shown in the figure below.

[1] The economic articulation of this is Pareto efficiency: a market is said to be Pareto efficient if it is not possible to make someone better off without anyone worse off.

Figure 1
Six evidential questions to help assess concerns about fairness in price discrimination

	- Lesser concern	Greater concern +
Who is harmed by price discrimination?	Wealthier consumers – e.g. time poor, cash rich	Customers with characteristics which might be deemed to make them more vulnerable (e.g. low income, old age, etc.)
How much are these individuals harmed?	Profitability difference between consumer segments is minimal and is immaterial to those who are harmed	Significant profitability differences and the harms suffered have a significant adverse effect on those who are harmed
How significant is the pool of people harmed?	Very small minority	Significant group of customers
How are firms discriminating on price?	Transparent and based behaviour which consumers can easily change (e.g. switching)	Hidden and based on intrinsic characteristics which consumers cannot easily change (e.g. personal characteristics)
Is the product/service essential?	Product/services is considered non-essential but desired by some consumers	Essential product/service (e.g. current account or motor insurance)
Would society view the price discrimination as egregious/socially unfair?	Little concern expressed about practices and firm behaviour widely accepted	Persistent and broad-based concern expressed and firm behaviour seen as poor conduct

Source: Financial Conduct Authority: Fair pricing in financial services, Discussion paper 18/9, October 2018

Much of the FCA's framework is based on traditional approaches to quantifying economic harm: the quantum of harm, the number of people who are affected and the nature of the harm. The new areas covered by this framework include an emphasis on societal views – which can be difficult to decipher at the best of times.

Another recent financial services development is the FCA's report on their thematic work on the pricing practices of household insurance firms, published last October. On the back of this work, the FCA wrote to the CEOs of general insurers, requiring them to "act now to address any issues from the findings in our report". The review highlighted three major areas of concern:

- Firms failing to have appropriate and effective strategies, governance, control and oversight of their pricing practices and activities, such that they are unable to reliably assess and demonstrate whether they are treating their customers fairly.
- Differential pricing leading to some identifiable groups of consumers paying significantly higher prices than others with similar risk and cost-to-serve characteristics.
- The risk of discriminating against consumers through using rating factors in pricing based directly or indirectly on data (including third-party data) relating to or derived from protected characteristics.

The report marks a significant shift in the approach of the FCA, which is clearly focusing more closely on issues of fairness. The upshot is that firms are likely to have to think more carefully in future about how they justify their pricing practices. All this is bound to take up even more of senior management's time.

The FCA is currently gearing up to undertake a study of the general insurance market as whole. It is safe to assume that fairness in pricing will be one of the focal points of the investigation.

What next?

The underlying economics and techniques to explore the fairness of pricing outcomes are unchanged. What is new is heightened political scrutiny of pricing practices in response to growing public disquiet about “rip-off” tariffs, especially in essential markets. As a result, the chances are that lawmakers and regulators will turn to more-onerous structural, outcome-focused remedies such as price caps. Indeed, Ofgem has already capped energy bills on Parliament’s instruction.

Firms need to respond to the changing environment by ensuring they have a comprehensive understanding of their pricing models and outcomes. Fairness has become a priority issue that now demands the attention of top management. Delegating the matter may have been an option as recently as last year. No longer.

More subtly, technical regulatory arguments may no longer cut through. The growing clamour around fairness makes it imperative for firms to have a good communications strategy in place. They need to comfortable defending their pricing outcomes and policies not just to regulatory professionals and lawyers but also in the court of public opinion.

Antti Lemberg

+442070317000

antti.lemberg@frontier-economics.com