

Agenda

Advancing economics in business

Behavioural problem, behavioural solution: the case of extended warranties

Consumers do not always behave fully rationally. In some cases their purchasing behaviour can be a contributing factor to concerns about competition and poor market outcomes. Can interventions that help to inform consumers and influence their behaviour be more appropriate than more structural interventions in these cases? The extended warranties market is one example where access to information has been improved in order to resolve a competition authority's concerns

The effect of consumer (and, in some cases, company) purchasing behaviour on competition is currently being assessed by regulators and competition authorities in several sectors. For example, the UK Office of Fair Trading's (OFT) study into retail banking in the UK is looking at consumer engagement with banking services.¹ Similarly, Ofgem's domestic retail market review is considering the extent to which consumers engage with energy tariffs.² The UK Competition Commission's (CC) investigation into the audit market is looking at why companies tender their audit services only infrequently.³ In each of these examples, customer behaviour is relevant to the competition authority's theory of harm. This raises the question of whether addressing these behavioural traits would be sufficient to remedy any competition problems.

The OFT's recent study into the UK's extended warranties market is an example of where consumer behaviour was allegedly contributing to concerns about the functioning of the market.⁴ In this case, the three largest retailers concerned (Dixons, Comet and Argos) offered to implement a number of measures aimed at increasing the information available to consumers and therefore aiding their decision-making. The OFT decided to accept these undertakings, considering them to be sufficient to address its outstanding concerns, and hence avoiding the need for a market investigation reference. This was notable, since it was only the second time that, having found that the criteria for a reference were met, the OFT had accepted commitments from providers in lieu of a referral.

This article considers the role that these undertakings might have in influencing consumers of extended warranties, and, more generally, whether behavioural problems in markets can have 'behavioural' solutions.⁵

It also discusses how the way in which consumers behave in after-markets can influence the appropriate market definition, and consequently whether competition concerns in one market can affect another market.

Consumer behaviour in purchasing extended warranties

Consumer purchasing behaviour was one of the key issues investigated by the OFT in its market study of extended warranties. Extended warranties are service products that supplement the usual one-year manufacturer guarantee for domestic electrical goods.⁶ At a minimum, these warranties commit to repairing or replacing a defective product free of charge in the event of product failure. They are, however, differentiated products, and some providers offer more comprehensive customer support packages than are included in the manufacturer's guarantee. For example, some extended warranties include extra services such as technical support and accidental damage cover. In general, the OFT found that the product offering has improved over the last decade, with enhanced service quality and lower fixed-term prices.⁷ It is worth noting that it is also possible to purchase extended warranties through a range of sales channels, including from the retailer, directly from the manufacturer, and from insurance companies.

The OFT considered that, given the variety of product features available, consumers did not always have the right 'choice tools' to understand and evaluate the suitability of the products on offer.⁸ The OFT was also concerned that consumer awareness of alternative providers was limited, and considered that the extent of shopping around for extended warranties is relatively

low—according to a survey, approximately 25% of consumers shop around,⁹ and 71% of consumers bought extended warranties at the same time as an electrical item.¹⁰

In order to address these concerns, the three largest providers of extended warranties offered to make undertakings in lieu of a referral to the CC. These undertakings are designed to facilitate consumer decision-making, by making it easier for consumers to access information about the different choices available in the market. The main features of the undertakings involve the following.

- **Price comparison site**—the three main providers will maintain and publicise a price comparison website and permit access to any other provider wishing to place its products on the site.
- **Alternative providers**—the three main suppliers will provide more information about alternative providers via in-store leaflets, with the intention of helping consumers to shop around.
- **PAYG**—the three main providers will display annual equivalent prices for pay-as-you-go (PAYG) products. Although the OFT had concerns about PAYG pricing, for many products (such as gym membership), it is normal for them to be available on a monthly PAYG basis as an alternative to paying the full price up front. Note that, in the PPI case, single premiums were banned and, as a result, PAYG has become the standard.¹¹

The undertakings are concerned primarily with improving access to information for consumers. The price comparison website also helps consumers to assess the information by making comparisons of the relative merits of the prices and features of products easier. The undertakings therefore address the first two stages of the OFT's 'Access, Assess, Act' framework for consumer behaviour.¹² Improvements in the first two stages of the consumer decision-making process should also influence the final stage (ie, how consumers act when making purchasing decisions).

The acceptance of the undertakings is particularly notable because it is a Decision that imposes no structural changes on the industry. This implies that the OFT believes that, with the right tools, consumers can act in the market to promote increased competition between providers. The OFT has indicated that:

Some behavioural change by consumers should increase the incentives for [extended warranty] providers to compete more effectively.¹³

The desire to influence consumer behaviour in this way is in keeping with the emerging behavioural economics approach known as liberal paternalism, or 'nudging'.¹⁴ This is the idea that it is possible to implement small measures to influence the way in which consumers make choices, and help them to make better decisions. For example, the price comparison website may help consumers to choose the extended warranty most suitable for them, but does not force them to make any particular choice or prevent them from purchasing at the point of sale if they wish to.

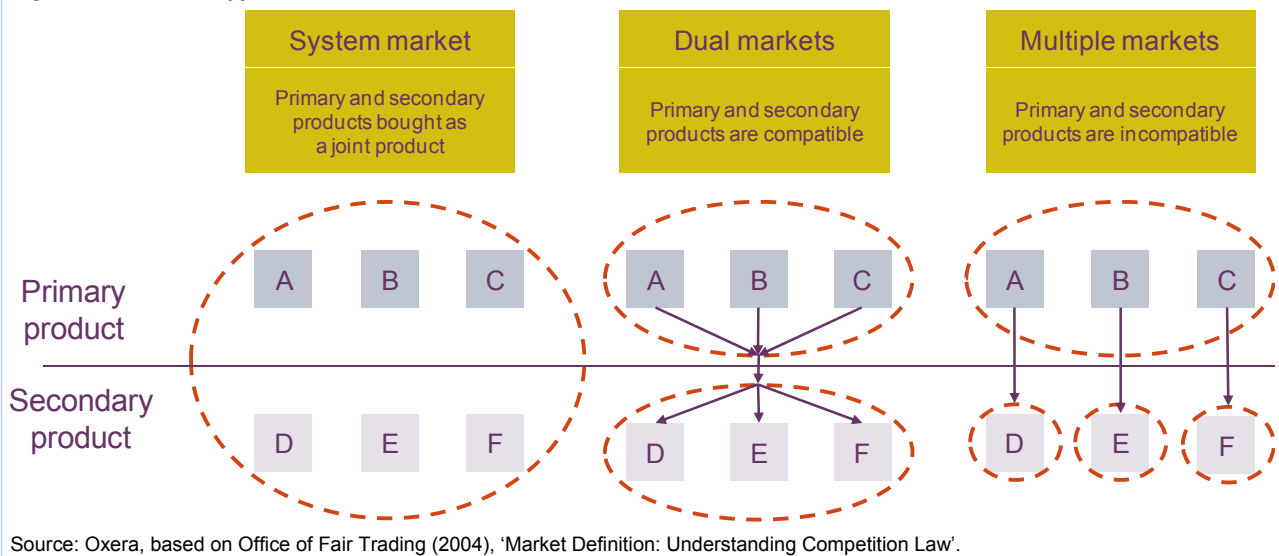
Consumer purchasing behaviour and after-market definition

In addition to behavioural matters, the extended warranty market study raised wider questions about the link between consumer behaviour and market definition in 'after-markets'. An after-market is a market for a product or service (known as a secondary product) that is used in support of, or as an add-on to, another product (known as a primary product). The secondary product is useful only in combination with the primary product, and hence is only bought once the primary product has been obtained.

Some consumers may view secondary products (eg, an extended warranty to go with an electrical product, or a printer cartridge for a printer) purely as features of the primary product. This can lead to a blurring between what is a separate market and what is a system/bundle market for complementary goods or services. The nature of consumer purchasing behaviour will affect the relationship between the primary and secondary markets, and this relationship will determine where competition problems, if any, are best remedied.

For example, after-markets can be broadly categorised into the following three types (also illustrated in Figure 1 overleaf), depending on the relationship between the two products:

- system markets, where consumers consider the primary and secondary products together when they make their purchasing decision. This is akin to treating individual products as product characteristics of a larger (system) product;
- dual markets, where consumers make separate decisions about the primary and secondary products, and providers in the primary market cannot leverage their position in the secondary market;
- multiple markets, where there is one market for all primary products and then unique after-markets for the secondary product associated with each primary product.

Figure 1 The three types of after-market

Understanding the relationship between the after-product (eg, the extended warranty) and the product itself (eg, the electrical good) is vital to obtain a full picture of the nature of the after-market. For example, market research has shown that consumers are more likely to buy extended warranties on white goods (such as fridges, freezers and washing machines) than on other electrical products.¹⁵

How consumers calculate their expected expenditure is one relevant factor. Where consumers make a purchase based on an estimate of whole-life costing (their expected expenditure over the lifetime of owning that product, including initial costs, repairs, upgrades and add-ons) then a system market approach may be appropriate. This may be the case in a market where both the primary and secondary product are typically purchased only once (eg, in the case of fixed-term extended warranties), unlike with a product such as a printer, for which multiple cartridges are typically bought subsequently.

The pricing of primary and secondary products can also be relevant. Where retailers are inclined to offer a secondary product 'free' with a primary product then it is less likely to be appropriate to consider them to be wholly separate markets. For example, the UK retailer John Lewis typically offers an extended warranty in a bundle with an electrical good rather than as a separate product. This suggests that, in this case, the extended warranty may have become simply a feature of the retail offering.

Where competitive conditions differ substantially between the primary and secondary products, questions can arise about cross-subsidisation, which can lead to potential under-consumption of the 'subsiding' product and over-consumption of the 'subsided' product.

From a competition policy perspective, it is sometimes argued that such concerns are mitigated if there is sufficient competition in the primary product market for any excessive profits in the secondary market to be competed away in the form of lower prices in the primary market. In general, there are limits to this argument since, for these product arrangements to exist in equilibrium, the firms involved must make incremental profit relative to the counterfactual. Hence, even in the absence of excessive profits, there may be policy questions about any distributional effects from cross-subsidisation. This will depend on the characteristics of those purchasing the secondary product, particularly where only certain sub-groups of consumers (eg, young families) are involved.

Cross-subsidisation also occurs implicitly in many other markets. In fact, most retailers sell a range of products and earn a range of margins across them; this occurs in many markets, including groceries, where the success of the multiple retail offering relies on this model. In multi-product retail pricing, it is efficient to set different mark-ups for different products due to product complementarities. Other examples include cinemas, where the film ticket may be cheap but other products, such as popcorn, may be relatively expensive; and the car market, where a basic model can be priced competitively, but the 'optional extras', such as satellite navigation, may be costly. In supermarkets, the known-value items may be loss-leaders to attract customers to a store where high-margin products are also available. The CC acknowledged this point in its investigation into groceries:

Generally, it is optimal for grocery retailers to spread their fixed costs over as many sales as possible; the higher the sales of a grocery retailer, the lower the average cost, which, absent coordination, results in lower average

prices for a basket of groceries. They can achieve this if they set higher margins on those products for which consumers are less price sensitive and lower margins on those products for which consumers are more price sensitive.¹⁶

Concluding remarks

Consumer inertia or limited ability to evaluate products and value for money can lead to concerns over reduced or distorted competition. Where concerns with consumer behaviour arise from the limits of the information available to them, or their ability to process

the information, then measures which improve either of these are likely to lead to a more engaged pool of customers. By itself, improving the engagement of customers can sometimes be sufficient to facilitate competition and improve market outcomes. One of the key merits of this approach is that it does not remove choices from consumers; nor does it intervene to affect their ability to make their own decisions. In light of developments in behavioural economics, where there is a behavioural 'problem', competition authorities may increasingly be searching for a behavioural solution.

¹ Office of Fair Trading (2012), 'Review of Personal Current Accounts in the UK: Scope Document', July.

² Ofgem (2011), 'Retail Market Review: Domestic Proposals', December; and Oxera (2012), 'Economic Appraisal of Ofgem's Domestic Tariff Proposals: an Appropriate Intervention to Increase Customer Engagement?', March, available at www.oxera.com.

³ Competition Commission (2011), 'Audit Market Inquiry: Issues Statement', December.

⁴ Office of Fair Trading (2012), 'Extended Warranties on Domestic Electrical Goods: Final Decision on a Market Investigation Reference', June. Oxera advised one of the retailers throughout the OFT's study.

⁵ The term 'behavioural' is used here in the sense of remedies incorporating lessons from behavioural economics, which seek to address identified problems in consumers' ability and inclination to make effective purchasing decisions. This should not be confused with behavioural/behaviourist theories of human psychology.

⁶ During its study, the OFT focused on televisions, washing machines and personal computers.

⁷ Office of Fair Trading (2012), 'Extended Warranties on Domestic Electrical Goods: An OFT Market Study and Notice of the OFT's Intention to Accept Undertakings in Lieu of a Market Investigation Reference', February, para 1.6.

⁸ Office of Fair Trading (2012), 'Extended Warranties on Domestic Electrical Goods: Final Decision on a Market Investigation Reference', June, para 4.13.

⁹ *Ibid.*, para 1.5.

¹⁰ Mintel (2011), 'Extended Warranties – UK', May, Figure 37.

¹¹ Competition Commission (2011), 'Payment Protection Insurance Market Investigation Order 2011', March. See also Oxera (2009), 'Competition in Secondary Products: the Case of Payment Protection Insurance', *Agenda*, June.

¹² Office of Fair Trading (2010), 'What does Behavioural Economics Mean for Competition Policy?', March.

¹³ Office of Fair Trading (2012), 'Extended Warranties on Domestic Electrical Goods: Final Decision on a Market Investigation Reference', June, para 3.12.

¹⁴ See Thaler, R. and Sunstein, C. (2008), *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Yale University Press; and Oxera (2010), 'Behavioural Economics, Competition and Remedy Design', *Agenda*, November.

¹⁵ Datamonitor (2010), 'UK Extended Warranty Insurance 2010', p. 20.

¹⁶ Competition Commission (2003), 'Extended Warranties on Domestic Electrical Goods: A Report on the Supply of Extended Warranties on Domestic Electrical Goods within the UK – Volumes 1, 2 and 3', p. 50.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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