THIS ARTICLE focuses on essential services and argues that markets in industries such as utilities, telecommunications, banking, insurance and even health and education will result in simultaneous competition and monopoly, thereby thwarting the objectives of National Competition Policy (NCP). This situation arises because competition stimulates increased market segmentation which in essential services gives rise to market exclusion ('redlining') and residual markets. Moreover, segmentation results in cross-subsidies flowing from monopolised customers to those in the 'competitive' segment, undermining further the validity of the argument that deregulation promotes Pareto optimality.

Twelve years ago it was claimed that NCP would deliver $23 billion (in 1993-94 dollars) in savings and create 30,000 new jobs. NCP is currently under review by the Productivity Commission. Competition is a means to an end, and that end was Pareto optimality. In everyday language this means that, so long as the winners in markets gain more than the losers lose, the nation is better off. More technically it means the achievement of a 'position where the existing resources of the economy cannot be re-allocated without making somebody worse off.' Microeconomic market reform would capture the economic efficiencies that occur when competitive pressures are brought to bear, guaranteeing cost savings and lower prices.

**Market segmentation**

Until the 1970s few essential services areas in Australia were markets. Industries such as utilities, telecommunications and banking generally were state owned and/or regulated. Many were monopolies. Insurance had been under the control of a cartel until the Whitlam era. The same was true in the UK and the US. The exceptions were banking and insurance in the US, and it is the experience of these industries that provide an important lesson for 'competition' theory. It was in these markets that redlining was
High-value customers are HVCs, while unattractive ones are ... BOZOs – customers who 'bring only zero outcomes'.
Incoming telephone calls were screened in relation to area codes. Customers from 'bad' localities did not get through.

arrangements.

They go on to describe compulsory private sector vehicle insurance in Canada as 'de-selecting' the poor into a market sub-segment, where they are ruthlessly exploited, not just through higher premiums, but through credit provision to pay for these higher premiums, direct debit schemes and unfair termination penalties:

One of the ironies of insurance is that, while it is supposed to pool risks, in practice it tends to unpool them, breaking down the larger pool of potential insured in search of smaller, less risky pools, which are more advantageous for some, while excluding others. Premiums within these smaller pools can be kept lower and claims service can be higher, but only for those fortunate enough to be included. Insurance, as they observe, is the basis of the welfare state as all risks (such as poverty in old age) are pooled.

Knights, Sturdy and Morgan argue that regulatory changes to stimulate competition, and changes to the socio-economic profile of the population, were two crucial elements promoting market segmentation of deregulated UK financial markets. They observed that 'market saturation of certain core products' arising out of increased personal incomes in the 1980s initially encouraged segmentation. This was followed by economic recession and the housing crisis that focussed managerial attention more acutely towards costs and profitability as well as new markets. The decline in household wealth resulted in efforts to 'select out' low profit customers. Similar observations have been made in the insurance industry.

Leyshon and Thrift argue that information technology and credit scoring as they are now applied in the UK retail banking sector permit sellers the 'knowledge competency' to overcome the information asymmetries that lenders confront in their dealings with potential customers;stitution.

Traditionally, there are two ways in which lending institutions have sought to circumvent the problem of information asymmetries. The first has been to accept that these problems are intractable, and opt for a method of 'pooling equilibrium', setting an interest rate that ensures that excess demand for debt, and then choosing borrowers at random from all the applicants. However, this passive method of selecting borrowers can be safely abandoned if lenders are able to identify significant characteristics displayed by potential borrowers that might indicate whether or not they will be 'capable' or 'incapable'. Therefore, in order to overcome information asymmetry, retail banks have attempted to collect information about customers in order to be able to be knowledgeable about what sorts of people are 'good' and 'bad' customers...

... credit-scoring systems, in becoming the obligatory point of entry to the retail financial system, have set new conventions for deciding who is a 'good' and who is a 'bad' consumer, producing new patterns of inclusion and exclusion. Credit-scoring systems and an intensification of competition within the industry may well have brought about an absolute increase in levels of financial exclusion, but they have also brought about increases in relative levels of financial exclusion; that is, financial exclusion is now a problem which overwhelmingly afflicts the poorest and most disadvantaged sections of society. Such marginal groups constitute a large and growing proportion of those excluded from financial services, so that if an individual lacks access to a basic financial product such as a current account then they are in all likelihood living in poverty and suffering from wider problems of social deprivation. It is clear that many people, because they are poor, have an irregular employment history, have encountered problems with debt in the past or have had no previous contact with the financial system are effectively 'invisible' to financial institutions (authors' emphasis). Leyshon and Thrift identified the use of telecommunications systems and information technology in the attraction or avoidance of customers. Incoming telephone calls were screened in relation to area codes. Customers from 'bad' localities simply did not get through. 'Good' customers received faster connection to an operator and their loyalty was rewarded. Competition and new technology had also removed the emphasis on a network of branch offices. This allowed easier entrance into the market for new competitors and increased cherry-picking, that is, positive discrimination in favour of affluent (attractive) customers. This in turn meant existing financial service providers came under pressure to further limit their exposure to possible bad loans (as the margins in the pool across which risk was spread dropped) and more potential customers were denied access to services.

Evidence of segmentation permeates a number of markets. The Consumer Federation of America claims there is a 'digital divide' in which telecommunications customers are segmented and discriminated against. The emergence of web-logging – the use of the internet to segment markets – and the potential for abuse has been explored. Even food retailing has been scrutinised. The University of Newcastle-upon-Tyne found that privatisation and restructuring resulted in private sector service withdrawal from low-income neighbourhoods; and, as a general rule, the poorer the access to a service, the more it cost. McDonnell and Westbury argue...
that deregulation of banking in Australia has led to discrimination against low-income customers, predicated on the combination of producer power and the essentialness of the service. The Parliamentary Joint Standing Committee on Corporations and Securities noted that, ‘fees do not apply equitably, with high value customers given exemptions while high transaction and low balance customers pay disproportionately more for what is fundamentally an essential service’. A recent Australian study by Stagoll and Lynch argues that the homeless are discriminated against on the basis of social status. However, their conclusion that ‘the chronic shortage of affordable, appropriate housing, together with the obvious fact that homeless persons need housing, creates a situation that is often exploited by landlords and proprietors’ arguably supports a view that rational economic discrimination — not social discrimination — is being practised.

Marginson identified segmentation in emerging education ‘markets’ in Australia and elsewhere, and the formation of a residual education market comprised of government schools lacking the resources to compete. He argued segmentation in education exacerbated socioeconomic disadvantage. This view is supported by a review of literature of nine British public service fields that specifically examined the experience of individual choice in these services. In terms of distributional outcome it identified:

... a situation in which the market separates into a ‘sink’ sub-sector of under-performing suppliers located in disadvantaged areas unable to attract good staff and for which there are falling levels of consumer demand and no competition between consumers for access, and an ‘elite’ sub-sector of high performing suppliers located in wealthy, leafy areas able to attract good staff, with high levels of application, where there is congestion, and where in effect the suppliers choose the consumers.

The separation of sub-sectors is described as ‘polarisation’. The review noted that the research in the education sector appeared to reveal that ‘polarisation limits competition, unless regulation limits its effects’.

Cross-subsidies

The effect of having a market segment that can be exploited economically is that the profits can be used to fund the competitive discounts offered to attractive customers. Research by Knights, Sturdy and Morgan on financial deregulation in the UK identified the withdrawal of many low margin products, which they believed was intended to limit consumer choice to more expensive and profitable services. Moreover, they believed that industry executives understood that competition for the most profitable customers had led to discounted premiums for those customers at the expense — in the form of higher premiums — of lower-income households. In some cases, governments aid the process of cross-subsidisation by creating safety nets that constitute state-sponsored residual markets. This is true of the standing offer tariff in Victoria’s new electricity markets and its equivalent in other states. Unattractive households are left on the standing offer because they cannot obtain a less expensive market contract, yet the cost of supply and risk of default do not, for the most part, justify the price they pay. This profiteering provides a source of revenue to fund discounts on market contracts that are offered to attractive customers, without disturbing the bottom line.

Marginson also made an astute observation that liberal theory seems to imagine the existence of a single ‘borderless contestable market’. Markets are not homogenous or static, nor can the concept of ‘sub-market’ explain the relationship between their different ‘bits’. Edwards argues the term ‘sub-marks’ has been used to suspend the delineation of a ‘relevant market’ at too high a level by referring to smaller loci of significant pricing discretion as sub-markets rather than recognising them as relevant markets in themselves. If market segmentation is, as Beaton-Wells, Beaton and Beaton-Wells argue, ‘a strategy used by suppliers to identify those segments within a market in which they might seek to establish a competitive advantage over their rivals, and thus enhance market share and profitability’ then it is clearly both about market power and more specifically about identifying customer segments that lack it. They argue that investigation of market power issues in Australia under Part IV of the Trade Practices Act (that is, in anti-competitive conduct cases) would be enhanced if market segmentation as an analytical tool replaced the disputed concept of ‘sub-market’. This would work to resolve the judicial ‘confusion over the distinction between sub-markets and market dimensions’ on adoption of a market segmentation method... would facilitate a more theoretically robust, systematically applied and commercially insightful resolution of the issues raised in competition cases involving potential abuse of market power.

The question from a public policy perspective is whether the application of NCP to essential services invites abuse of market power. If consumption is not discretionary, does it invite the exploitation of ‘sitting ducks’ who will be captured in a residual market? What can prevent the exclusion of the BOZOs? In the US banking and insurance industries, neither prohibition of ‘redlining’ nor mandatory community reinvestment have managed to overcome the rational and legitimised economic discrimination that lays behind ‘redlining’. The big question for the Productivity Commission is just how segmented are our essential services. We all know that small bank account holders and low consumption telephone users get the rough end of the competition stick. The standard pat answer that these customers are merely paying their way now is not satisfactory when there is little evidence on the table to support such claims and when the opportunity to engage in abuse of market power is so apparent.

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Footnotes
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