

SAVES AND WIN-BACKS

BACKGROUND, SCOPE AND PRELIMINARY PROBLEM DEFINITION

MARKET DEVELOPMENT ADVISORY GROUP

The post-implementation evaluation of the saves protection scheme found that the scheme had no effect on retail competition and that win-backs were substituted for saves with no overall change in switching activity. The question is whether there are problems with the customer acquisition process that result in a non-level playing field for acquiring retailers, including new retailers. This paper sets out background information and potential issues for investigation to inform an issues paper. At this point, one of the key questions identified is whether or not workable competition is undermined by uneven access by retailers to information about customers, and if cherry-picking could affect the long term durability of the market. These questions will be explored and tested empirically, to inform an issues paper.

Note: This paper has been prepared for the purpose of developing an issues paper on whether there are problems with the customer acquisition process that may warrant work on any intervention. Content should not be interpreted as representing the views or policy of the Electricity Authority.

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1. Purpose

This paper sets out the issues to be considered in the production of an Issues Paper on whether there is a regulatory problem or market failure relating to customer acquisition, including saves and win-backs practices.

Guiding questions for this project are:

- a) are there problems with the customer acquisition process that result in a 'non-level playing field' for acquiring retailers, including new entrant retailers?
- b) to what extent do perceptions around a potential 'non-level playing field' affect the durability of the retail electricity market and, if so, would this warrant regulatory intervention on customer acquisition, including saves and win-backs?

Subsequent work would consider if the saves protection scheme should be amended and, if so, how, and whether there are other regulatory mechanisms that should be considered.

This paper discusses:

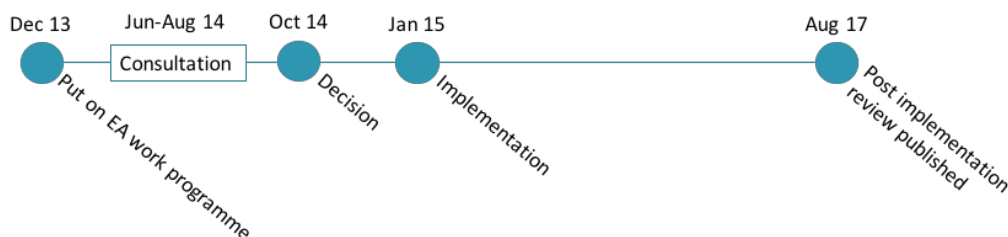
- background information on past work on customer acquisition issues
- issues for investigation to inform the issues paper (preliminary problem definitions)
- analysis required and project timelines.

2. Past work on customer acquisition issues

2.1 Saves and win-backs

A save is when a losing retailer persuades a customer to cancel an incomplete switch and a win-back is when a losing retailer entices a customer who had switched to return.

The following figure summarises past work undertaken by the Electricity Authority (Authority) on the issue.



Consultation paper

The June 2014 consultation paper states that saves and early win-backs – those occurring shortly after the switch – are likely to have a net negative effect on retail competition.

The reasoning is that, unlike in most other sectors, the incumbent supplier gets advance notice that it is about to lose a customer and can use this information to 'save' the customer. As a result, the effectiveness and profitability of an acquisition campaign is reduced, creating an entry and expansion barrier for small and new retailers. The Authority sees (the threat of) new entry in particular as important for vigorous competition.

The Authority proposed an opt-in save protection scheme. When the gaining retailer opts-in, a losing retailer would not be allowed to persuade a customer to cancel the switch or switch back, from the time of being notified of the switch to ten business days after the switch. The save-protected retailer would also not be able to engage in saves and early win-backs.

An opt-in scheme was preferred so suppliers could decide for themselves if saves protection was of value, in line with the Authority's preference for non-prescriptive trial-and-error solutions when there is no clear single best option for addressing an identified problem.¹

Saves protection would mean that some consumers may no longer benefit from retention deals. But the Authority considered that the change would be of long-term benefit to consumers because save protection would promote retail competition through increasing the returns to acquisition campaigns (lowering barriers to entry and expansion for smaller and new entrant retailers), and through encouraging incumbent retailers to pre-emptively offer their existing customers the best deal.

The benefits from increased competition, innovation, and/or dynamic efficiency were not quantified but were expected to exceed the relatively small costs of the proposal. These costs were expected to consist of compliance costs, increased acquisition retention and win-back costs, and increased retailer overheads.

Submissions

In general, submissions highlighted opposing views on whether saves and early win-backs are a problem.

One view is that saves and early win-backs create an uneven playing field for small and new entrant retailers, and that allowing some consumers to get a better deal than others (including through cherry picking) undermines transparency which would reduce confidence in the market.

The other view is that there is already healthy retail competition, that the saves and early win-backs process is beneficial to consumers, that the save rate is generally low (especially for the smallest retailers), and that it is not clear that saves or early win-backs are detrimental to new entrants or that blocking saves would improve competition.

¹ An application of the tie-breaker 1, principles 4 and 8, in the Authority's Code Amendment Principles in the Consultation Charter (2012) available at <https://www.ea.govt.nz/code-and-compliance/the-code/amendments/amending-the-code/>. Principle 4 is a 'Preference for Small-Scale Trial and Error Options'. Principle 8 is a 'Preference for Non-Prescriptive Options'.

None of the submissions presented conclusive evidence in support of either view. Genesis did refer to data showing high switching rates, a declining market concentration index, and four new entrants in the last 12 months.

Submitters generally agreed that early win-backs were similar to saves, but there were different views on what 'early' meant.

Decisions and reasons paper

In October 2014, the EA decided to amend the Electricity Industry Participation Code 2010 (Code) to allow retailers to opt into a save-protection scheme, which prohibits retailers contacting customers they are losing until a switch is complete (the 'event date' in Schedule 11.3 of the Code). The scheme would not extend to early win-backs as was initially proposed, and customer-initiated saves would be unrestricted.

While the consultation document stated that early win-backs were equivalent to saves, and this was accepted by submissions, the Authority concluded a restriction on win-backs was not necessary at this point because:

- a win-back does not rely on information provided for the switch process
- there was no evidence win-backs were a problem for competition
- gaining retailers could mitigate this risk (e.g. fixed term contracts).

The Authority did comment that the use of the switch withdrawal process (within 2 months of the switch completion date) was undesirable unless it was to correct an error. It also stated that it would monitor win-backs and that, if the process was being used frequently, it may ask retailers to collectively agree not to use the switch withdrawal process (except to correct errors) or to amend the Code to prohibit it (para 4.2.9).

The report canvasses a number of other issues (slamming, overly pushy marketing and door to door and telemarketing sales, misinformation, fixed term contracts, last look clauses), but notes these are covered under the Fair Trading Act 1986 or other complaints processes.

The Authority decided that a review would be undertaken within two years of the scheme coming into effect.

Evaluation

At the end of August 2017, the Authority published a post-implementation review. The method involved analysis of switching data before and after the scheme (with some break-down by save- and non-save-protected retailers), and a survey of providers and consumers.

The evaluation found:

- a decrease in saves, offset by an increase in win-backs, with little net overall impact
- an increase in switching speed for both save-protected and non-save-protected retailers, from an average of 97 hours to 82 hours (p21)
- a reduction in the average time that a switch survives before being withdrawn, from 362 to 316 hours (p26)
 - the switch withdrawal time was shorter on average for non-save-protected retailers (271) than save-protected retailers (389) (p28)

- the probability of a switch being withdrawn within 1,344 hours was unchanged at 10% (p26)
- a slightly higher probability of a save-protected switch surviving 2 months (83.5%) than for a non-save-protected switch (83.3%) (para 7.43)
- an indication, given these findings, that save-protection led losing retailers to speed up the switching process so they could start the win-back attempt (para 7.47).

The Authority noted that retail market competition had continued to improve, based on a number of measures, but that this was unrelated to the scheme – the number and market share of small and medium retailers had continued to rise, and switching had stayed at around the same level as before the scheme.

It concluded that there was no evidence the scheme improved or harmed retail competition. It noted that survey respondents indicated cost to acquire customers had increased since the scheme was introduced, but that this may be partly due to other factors.

The Authority concluded that saves and win-backs should be considered together because they are substitutes (Para 4.1). It also found that “the problem of the losing retailer being notified that their customer is about to leave has not changed” (para 13.2), and that “further measures are required to improve the effectiveness of the scheme” (para 13.6).

The Authority also concluded that “notification of an impending switch, in itself, may not be a material advantage” because other privately held information about a customer’s characteristics may be a more important source of informational advantage (para 13.5). Part of the thinking behind this assessment was that an exchange of information about a trade or a switch of a customer is in fact essential and unavoidable in many markets.

Practices elsewhere

The Authority’s consultation document referred to international experience. This is summarised and updated below.

There are two situations where save-protection has been implemented – one was to support fledgling competition in previously monopolistic markets (landlines and cable), and the other related to privacy law, where a US Court found information provided to enable switching could not be used by that provider for other purposes (such as saves).²

Telecommunications

- In New Zealand, marketing to switching landline customers was prohibited to promote competition in the then new retail market. There are no restrictions in the mobile market
- There are no save restrictions in Australian telecommunications
- Losing retailers cannot use switch notifications to save telecommunication customers in the US as this information was provided for the purpose of switching (a privacy law point)

² This may need to be explored in the context of New Zealand’s Privacy Act 1993, in particular Principle 10 which limits the use of personal information to the purpose for which it was collected.

- In Canada cable companies were not able to market to customers for 90 days after notification of cancellation, but this restraint was eliminated in 2007 when there were no longer concerns about competition
- In the UK, OFCOM was of the view that saves discourage market entry, but it recognized the alternate view that saves are beneficial to customers. It concluded the net impact was an empirical matter that comes down to:
 - the relative size of the switcher and non-switcher customers
 - their responsiveness to price
 - the state of competition
 - whether suppliers can target more profitable customers, and
 - the switching effort and cost
- In December 2017, OFCOM decided to make switching of mobile providers quicker and easier for consumers.³ Unwanted reactive save offers were one potential source of difficulty that consumers experienced. OFCOM concluded that a quicker switching process would significantly reduce the window for the losing provider to get in touch with the consumer, but also that any consumer could simply reject unwanted contact. OFCOM commented that it expects providers not to use the switching process to retain customers and suggests providers could develop an opt-in or -out mechanism for consumers who do or do not welcome reactive offers.

Retail energy

- In the UK, OFGEM was monitoring the saves issue. It required retailers to offer a limited number of tariffs in consistent formats, which effectively eliminated the ability to offer special deals to selected switching customers
- In September 2017 OFGEM released a consultation document proposing to introduce reliable next day switching, which would “eliminate” saves as a potential issue.⁴
- The Australian Energy Market Commission, in its 2017 retail energy competition review, noted that the sector is competitive and that switching rates are higher than other sectors like insurance, and mobile phones, but that plans are harder to compare. Around a third of consumers investigated options to switch in the last 12 months and half of them did switch. It found that consumers needed to be offered a 23% reduction in their energy bill to consider a switch⁵
- The ACCC is undertaking a review on retail electricity supply and pricing (expected in June 2018). Its preliminary report dated 22 Sept 2017 concluded there was insufficient competition in the generation and retail markets. On the retail side, it highlights the types of issues with saves that have been raised by the Authority, with some retailers commenting on an uneven playing field and aggressive strategies to save or win back

³ https://www.ofcom.org.uk/data/assets/pdf_file/0023/108941/Consumer-switching-statement.pdf

⁴ https://www.ofgem.gov.uk/system/files/docs/2017/11/delivering_faster_and_more_reliable_switching_consultation.pdf

⁵ <http://www.aemc.gov.au/Markets-Reviews-Advice/2017-Retail-Energy-Competition-Review/Final/AEMC-Documents/Final-Report.aspx>

customers, and proposing intervention, though other submitters dispute saves are an issue.⁶

2.2 Other customer acquisition and retail competition initiatives

The work on saves and early win-backs forms part of the Authority's broader programme to promote competition in the electricity retail market – in line with its statutory objective to “promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.”

This work includes creating a level playing field for suppliers and “promoting to consumers the benefit of comparing and switching retailers”, one of the Authority's functions under the Electricity Industry Act 2010 s 16(1)(i).

This emphasis originates from the 2009 Ministerial Review of Electricity Market Performance which found that there was insufficient competition in the retail market, resulting in excessive retail price increases compared to increases in the cost of new supply, and growing and relatively high retail profit margins.

From the time of its establishment, the Authority has promoted switching, through improving consumer access to price comparisons (e.g. Powerswitch), an award-winning ‘what's my number’ advertising campaign to raise consumer awareness of the benefits of switching, initiatives to reducing switching times, and data initiatives to free up access to individual consumption data to allow consumers to test the market and for new price comparison and switching services to enter the market to intensify competition.

There has also been an emphasis on levelling the playing field for retailers, and to promote entry and expansion of new retailers to increase competitive pressure in the market for the long-term benefit of consumers. This included the transfer of assets (including virtual asset swaps) among some SOE generator-retailers and allowing lines companies to offer retail services. Changes to prudential and settlement arrangements⁷, and work on a default distributor agreement and hedge markets (including market making of ASX futures and the development of FTRs) all aim to make it less costly and easier for retailers to enter the market and expand.

More recently, the Authority has embarked on a review of switching processes and is consulting on costs and benefits of enabling consumers to use multiple service providers (the ‘Multiple trading relationships’ consultation).

The ‘Multiple trading relationships’ consultation also sits within the Authority's broader work programme on ‘Evolving technologies and business models’. This programme covers initiatives to reduce inefficient barriers to development and use of evolving technologies and business models across the supply chain.

⁶ <https://www.accc.gov.au/system/files/Retail%20Electricity%20Inquiry%20-%20Preliminary%20report%20-%202013%20November%202017.pdf>

⁷ These changes enabled retailers to have more customers with the same prudential securities in times of high spot prices, and reduced the amount of cash needed for settlement (freeing up working capital e.g. for expansion)

3. Issues for investigation

3.1 Are retailers simply competing or inadvertently undermining competition?

The central claim behind the saves protection scheme was that saves reduce returns to acquisition activity and thus reduce the amount of competitive activity in the electricity market.

A key factor in the Authority's deciding to act was that incumbent retail providers have 'inside information' about switching customers and, through the switching process, are warned of switching customers' intention to switch. The saves protection scheme was intended to level the competitive playing field by limiting losing retailers' use of their informational advantage.

The post-implementation evaluation of the saves protection scheme found that the scheme had no effect on retail competition and that win-backs were substituted for saves with no overall change in switching activity.⁸

Two opposing interpretations of these observations are that saves and win-backs show:

- a) retailers are competing for customers
- b) retailers are undermining competition.

Where does current market behaviour sit between these two extremes?

Drawing a line between these two extremes requires understanding competitive strategies and why and how win-backs occur. To do this it is useful to set out the different factors, at a high-level, which affect customer acquisition and retention strategies and market switching dynamics.

It can be taken as given that switching, and customer acquisition campaigns and strategies are, in general, a good thing. But the specifics of these strategies may cause problems.

There are three areas in which problems can occur, or at least where it is in the consumers' interest that these potential problems are monitored and managed:

- 1) abuse of market power through e.g. predatory pricing (discounting below cost to limit growth in a competitor's market share or as a barrier to entry)
- 2) misleading claims
- 3) information asymmetries which cause prices to be higher than they 'need' to be⁹ because
 - a) some retailers cannot accurately identify costs of serving consumers
 - b) some retailers, with an informational advantage, can profit from that information.

The first two of these potential problems, while important in general, are already subject to regulation under the Commerce Act 1986 and Fair Trading Act 1986, for example. The Authority might investigate such matters, if evidence warranted it, to check for any

⁸ Although win-backs may be sufficiently different to saves that this substitution has resulted in changes in retail competition and that has not yet been detected.

⁹ Or quality to be lower than it needs to be.

contributing problems related to market or industry regulation. However, because these matters are subject to pre-existing regulation and oversight¹⁰ they are not considered in any further detail, except to the extent that the Authority can undertake initiatives that promote competition and mitigate market power.

Informational advantages or deficiencies and uncertainty are at the heart of potential problems with customer acquisition strategies.

3.2 Is workable competition undermined by informational problems?

Search costs can be barriers to entry and impediments to competition

In an active campaign to acquire customers, retailers would contact a range of potential customers, some of whom will have no desire to switch or to engage in a discussion about switching. Searching around for customers who might like to switch comes at a cost. But, if you know that a person is apt to switch, then costs of searching for switchers will go down.

Imagine that there are two types of customers: movers and stayers. And imagine that people switch between types from time to time. When your customer chooses to switch to another retailer that is proof that they are a mover – at least for a while. The chances of successfully (re-)acquiring that customer is, in general, much higher than acquiring new customers from other providers. There will still be some cost associated with contacting and convincing the customer, but search costs are low or zero. Arguably, you'll pay up to your avoided search costs to keep that customer.

This implies that retaining a customer, through a save or a win-back, is a sound strategy employed for good economic reasons and may even reduce overall costs of competition (as compared to a situation where, hypothetically, retailers could not compete for saves or win-backs). At the same time, the acquiring retailer may bear the (search) costs associated with causing the customer to reveal their type.

This dynamic could be a barrier to market entry. New entrant retailers face search costs but not reduced costs of retention, because they have no or few customers to save or win-back.

Increased rates of market entry in the past decade and the fact that saves and win-backs are a minority of switches (less than 10%) both suggest that search costs have not been a significant problem.¹¹ It could, however, become one in future, at least in principle.

Further analysis is needed of the dynamics of customer switching rates and acquisition costs to explore the extent to which search costs could be a material barrier to entry in future. This analysis will need to move beyond the sort of static analysis employed in the

¹⁰ Including the Authority's market monitoring function.

¹¹ This raises a question about the point at which there are 'enough' competitors in a market. Views and research on this matter have come up with mixed results and the answer is likely to be market specific. However, Bresnahan and Reiss (1991), in a classic article on the effects of market entry on competition and competitiveness effects, noted that gains from new entrants can be expected to decline rapidly as market share increases (beyond, say, 2-3 firms). And other research has pointed out that 'more' competition is not necessarily always better from an efficiency perspective (see e.g. Mankiw and Whinston (1986)).

Authority's saves and win-backs consultation paper to reflect the impacts of switching rates on market shares and costs of retailing over time.¹²

If asymmetric search and retention costs do create material barriers to entry, taking steps to mitigate those barriers would create a difficult trade-off between short term gains to consumers – from getting a better win-back deal now – and long-term gains from promoting competition. The impacts on consumers of reduced inducements and discounts will need to be quantified.

Furthermore, we will need to investigate whether these issues are primarily a problem for retailers employing relatively high cost acquisition strategies and whether or not innovation in (lower cost) acquisition strategies could work to nullify this potential source of incumbency advantage.

Private information can confer a competitive advantage

Incumbent retailers have an informational advantage over their competitors when it comes to knowing the characteristics of their existing customers and whether a customer is worth keeping. This advantage comes from having information about a customer's energy consumption, load profiles, expenditure, bad debts and a past loyalty (tenure with the company).¹³

Some customer attributes can be inferred, with error, by acquiring retailers by profiling potential customers using characteristics such as locations or by asking consumers about their characteristics (e.g. income and household size). In the case of bad debt, credit ratings can be used. However, acquiring this information comes at a cost. And, retailers may spend time and money searching for and profiling potential customers only to find that a consumer is relatively high cost and relatively low profit.

Whether or not this informational advantage is a problem depends on exactly how useful this information is and hence the extent to which it constitutes a barrier to entry.

Knowing whether a customer is loyal or not may be one aspect of customer information that is quite valuable. But there is a sweet spot in consumer loyalty. An acquiring retailer needs a consumer to be a mover, to have much chance of securing their business. But extremely fickle consumers, who switch frequently, are also problematic because those customers may leave before costs of acquisition have been recouped.

Although acquiring retailers can require new customers to sign up to fixed term contracts, these contracts may reduce chances of winning new customers while incumbent retailers have enough information to target, for retention, those customers with a low chance of being fickle. Indeed, retailers who know a consumer's type can offer very good contract terms or one-off inducements to retain highly profitable customers.

In this context It can be useful to think of customers having 3 types: the frequent mover, the sometimes mover, and the stayer or never mover. As before, people can change type and a while a customer's current type can be predicted (with error), retailers can better predict their own customers' types than the types of other potential customers.

The possibility of acquiring a frequent mover exacerbates the search cost problem raised earlier. An acquiring retailer not only has to engage in costly search to find a mover, there

¹² A model of market switching could be used to help interrogate some of these dynamics.

¹³ Collecting and holding this information is not costless but is less costly to hold than it is for a competing retailer to acquire.

is also a risk that the mover is a frequent mover. This makes search even more costly and increases the incumbents' advantage from better knowledge about a consumer's type.

That said, if a losing retailer seeks to retain a customer that signals that the customer is a good bet. That being so, the information held by the incumbent is, at least partially, revealed to the acquiring retailer. That being so, more innovative acquisition strategies could take account of this information (such as by offering to provide a better 'deal' if the incumbent provides another offer).

Cherry-picking can cause market separation which may affect the long term durability of the market

Inside knowledge about customer attributes and potential profitability can cause markets to separate – where retailers end up specialising in particular market segments and customers 'sort' themselves to the kinds of providers which cater to them.

This issue, which follows from competitive advantage conferred by privately held information, was raised in the saves protection post-implementation evaluation of the saves and win-backs scheme. It was suggested that this could be a problem for the viability of entrant retailers (paragraph 13.8).

As separation – or sorting – can emerge for a range of reasons (such as a provider specialising to cater for specific customers), not just asymmetric information, it is not clear that separation would be bad for competition.

Further, it is not necessarily the case that only entrants would be negatively affected by sorting. It is also possible that incumbents would be worse off under a separating market. This depends on whether the mover type correlates with other attributes affecting customer profitability. For example, if 'never movers' are high cost (perhaps they are more likely to have bad debts or use more of a retailer's customer services) then increased switching could cause average costs of large retailers to increase as more profitable customers are acquired by newer entrants.

In other words, 'cherry-picking' is a strategy that is open to all retailers. As such, whether or not competition will be reduced through cherry-picking, is, in principal, ambiguous.

The scope for this kind of separation does raise concerns about the durability of the market if it means that high cost consumers face persistently higher prices – especially if high cost consumers are lower income consumers. This would happen if retailers systematically differentiate prices according to strict credit criteria and related profiling. Indeed, if prices were actively adjusted for profitability of individual customers this could lead to higher prices for low-use consumers. Concerns about costs of electricity for low users have already motivated regulation which has contributed to inefficient pricing practices.

This sort of concern is similar to insurance markets where separation or 'sorting' dynamics are a concern because they can undermine the ability of insurance markets to provide a valuable role in pooling risk. That is, low cost customers exit the market, leaving only high cost (high-risk) customers in the market.

While separation could have negative consequences, separation can also improve market efficiency because it involves increased specialisation in services to particular groups (e.g. actively managing bad debt rather than calling in the bailiffs or offering innovative prices and payment schemes to customers with high degrees of demand response).

3.3 Are there limits to informational advantages and their impacts on competition?

Changes in customer behaviour limits impacts of information problems

Customer acquisition and retention is a dynamic process and so too is a customer's demand profile and other characteristics. As a result, less profitable customers today can become more profitable customers later on. Even if it appears that entrant retailers are constrained in attracting profitable customers, they might still be able to build up a customer base which is going to be profitable in future as their customer base matures.

This suggests that there are alternative, dynamic, customer acquisition strategies which could allow retailers to build up information about their customers which then becomes an asset to the retailer.

If retailers can, at a cost, build up information about their customers and that information becomes an important proprietary asset, it may be unwise to treat that private information as a problem. Acquisition of private information and competitive advantage may be an inducement to compete – supporting competition in a workably competitive market.

To know whether this sort of competitive dynamic is a positive one there would need to be some analysis of the typical tenure of customers with their retailer, by consumer characteristics, to determine if this is a potentially profitable strategy which limits the informational advantage of incumbents.

Innovation can alter informational advantages

Even with predictable customer dynamics there is always scope for a change in market dynamics due to innovation. That being so, there may be no long-term benefits from mitigating apparent informational advantage.

There are two contrasting factors which will determine whether there are long term benefits from mitigating informational advantages in order to promote competition. One is the extent to which barriers to customer acquisition increase costs of customer acquisition and reduce returns to innovation. The other is the extent to which reducing acquisition barriers lowers returns to customer retention which would reduce returns to innovation.

If a retailer innovates to establish market share then the advantage of inside information may be a factor in supporting profitability. That is, informational advantages cut both ways in the sense that all retailers can benefit from it, once they are established in the market.¹⁴

Multiple trading arrangements, currently being consulted on, could be a significant institutional innovation which may have the effect of reducing the impacts of information asymmetry on customer acquisition and barriers to competition.

¹⁴ This is why the voluntary nature of the saves protection scheme is a good idea – because companies can determine for themselves if the benefit of lower cost retention is larger or smaller over the long run than increased acquisition (search) costs.

4. References

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Mankiw, N. G., & Whinston, M. D. (1986). Free Entry and Social Inefficiency. *The RAND Journal of Economics*, 17(1), 48–58