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8 February 2016

Dear Will

Please find attached a submission to the energy market investigation, entitled "The CMA energy market investigation, the well-functioning market, Ofgem, Government and behavioural economics".

The paper has direct relevance to some of the issues that arise in the CMA energy market investigation (and perhaps in the Retail Banking market investigation too, though I have not sought to appraise that).

This paper will be published in the *European Competition Journal*, March 2016. As from tomorrow it will also be available on the Energy Policy Research Group website at the University of Cambridge [www.eprg.group.cam.ac.uk](http://www.eprg.group.cam.ac.uk).

I confirm that there is no confidential information in the paper, and I am content for it to be published on the CMA website.

Sincerely

Stephen Littlechild

# The CMA energy market investigation, the well-functioning market, Ofgem, Government and behavioural economics

Stephen Littlechild\*

8 February 2016

## Abstract

The GB retail energy market, and Ofgem's regulation of it, have been controversial. In 2014 Ofgem asked the CMA to investigate. Its *Provisional Findings* of July 2015 take a similar approach to that of Ofgem since 2008. Both find weak customer response allowing unilateral market power, and support various regulatory interventions. The specific characterisation of the CMA's benchmark well-functioning market, with its requirement that firms have efficient costs, seems attributable to Ofgem. Possible reasons for similarities include Ofgem's involvement in the process before the CMA reference, policies of previous Governments including an initial strategic Steer to the CMA, and the increasing influence of behavioural economics especially via the OFT. Now the present Government has put in place a new Steer, without emphasis on consumer behavioural issues and with strong emphasis on deregulation rather than regulation. Experience and thinking about behavioural economics also continue to evolve. The paper discusses implications for the CMA.

## 1. Introduction

1. In 1998, GB domestic (residential) retail gas and electricity markets were opened to competition. Ofgem reported that competition was indeed developing and removed the transitional price caps. New products emerged and customer switching steadily increased. In early 2008, Ofgem assured the Chancellor that "the market is sound". Later that year, Ofgem changed its view and announced the first of a series of significant interventions in the market.
2. In June 2014 Ofgem referred the GB energy market for investigation by the Competition and Markets Authority (CMA). In July 2015 the CMA published its *Provisional Findings* and *Possible Remedies*.<sup>1</sup> The CMA agreed with Ofgem that the retail market was characterised by weak customer response that gave large suppliers unilateral market power. But it also found that some of Ofgem's regulatory interventions had had an adverse effect on competition. Its possible remedies included removing these interventions and replacing them by various other interventions including a form of price control.<sup>2</sup>

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<sup>1</sup> CMA, Energy Market Investigation, *Notice of Provisional Findings* and *Notice of Possible Remedies*, 7 July 2015, henceforth *Provisional Findings* and *Possible Remedies*.

<sup>2</sup> Ofgem, CMA and Government have also been concerned with other and wider energy market issues, on some of which (such as vertical integration and possible tacit coordination) the CMA takes a different view from Ofgem, but consideration of them lies beyond the scope of this already-long paper.

3. The CMA thus seems to have provisionally concluded that Ofgem was right in its post-2008 diagnosis but had simply chosen the wrong remedies to address the problem. This paper poses the question: why are the Ofgem and CMA diagnoses so similar?
4. The economic and intellectual case for those diagnoses is hardly so compelling that no reasonable person could come to an alternative view. Economists have long been critical of the retail aspects of Ofgem's policy.<sup>3</sup> I have shared that concern, and also expressed apprehension about the competition *Assessment Framework* that Ofgem, the Office of Fair Trading (OFT) and the CMA jointly prepared in December 2013, and in particular about the concept of the "well-functioning market" that provides the benchmark against which the actual market is judged.<sup>4</sup> These concerns are shared by other former GB energy regulators.<sup>5</sup>
5. One possibility is that events preceding the market investigation gave Ofgem an undue influence on the CMA's subsequent analysis. The first part of this paper, which revisits some of the issues raised in Littlechild (April 2014), explores certain aspects of the CMA's approach, notably its concept of competition, its interpretation of the benchmark 'well-functioning market', its application to the retail energy sector, the assumption that a well-functioning market would have efficient costs and the calculation of excess charges on customers. It shows that these aspects were not present in the work of the previous Competition Commission (CC). Rather, they reflect the approach set out in the joint *Assessment Framework*, particularly "Ofgem's vision", which in turn reflected Ofgem's approach dating back to the 2008 *Probe Initial Findings*. Moreover, the concept of the well-functioning retail energy market based on Ofgem's vision raises the question whether this approach is consistent with the CMA's *Guidelines* and with the Enterprise Act 2002 that provided for market investigations to be guided by competition issues and not by public interest considerations.
6. A second possibility, not inconsistent with the first, is that other factors might be leading both Ofgem and the CMA towards essentially the same approach. Via legislation and in other ways, Government influences the duties and

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<sup>3</sup> "There is almost a consensus among economists familiar with competition and energy market issues that, on the basis of best available knowledge, Ofgem's proposals to 'address undue discrimination' can be expected to have harmful consequences for consumers and for competition." Professor George Yarrow, *Response to Ofgem's consultation*, 11 May 2009. See also submissions by Professor Sir John Vickers, 1 May 2009 and Professor Catherine Waddams 13 May 2009. Hviid, M and Price, C W, "Non-discrimination clauses in the retail energy sector", *The Economic Journal*, 122, August 2012, 562. Michael G Pollitt and Aoife Brophy Haney, "Dismantling a competitive retail electricity market: Residential Market Reforms in Great Britain", *The Electricity Journal*, 27(1), January-February 2014, 66-73

<sup>4</sup> Stephen Littlechild, "Promoting or restricting competition? Regulation of the UK retail residential energy market since 2008", paper copied to the CMA energy investigation, 15 August 2014. A revised version dated 20 August 2014 is available at [www.eprg.group.cam.ac.uk](http://www.eprg.group.cam.ac.uk) Stephen Littlechild, "The competition assessment framework for the retail energy sector: some concerns about the proposed interpretation", *European Competition Journal*, 10 (1), April 2014, pp 181-202.

<sup>5</sup> Submission to CMA on "Summary of Provisional Findings Report and Notice of Possible Remedies", Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall, Stephen Smith and Clare Spottiswoode, 16 July 2015, at [www.gov.uk/cma-cases/energy-market-investigation](http://www.gov.uk/cma-cases/energy-market-investigation)

approaches taken by sector regulators and competition authorities. Indeed, the Coalition Government created the CMA as the successor body to the CC, and took power to give the CMA a non-binding strategic Steer. Although both the CMA and Ofgem are formally independent entities, it is possible that the influence of Government policy is a common thread in both their approaches.

7. The second part of this paper therefore examines the evolution of the Government's approach to competition policy and regulatory policy, with particular focus on the retail energy sector, under the Conservative, Labour and Coalition Governments since 1979. The multiple steps taken by Government to influence or modify regulatory and competition authorities are a noticeable feature. Another feature is the increasing influence of behavioural economics on Government, Ofgem, the OFT, the CC and the CMA, including as reflected in the CMA's *Guidelines*. The Coalition Government's Steer to the CMA reflects both developments. As a result, put simply, the similar approaches taken by Ofgem and the CMA energy market investigation to date are precisely as intended by the Coalition Government but may also reflect the common influence of behavioural economics thinking.
8. In May 2015 the new Conservative Government changed the emphasis of policy. Its revised Steer to the CMA removed the direction to focus on consumer behavioural issues and emphasised the importance of removing unnecessary regulatory burdens. Separately, there is accumulating evidence about the often-unintended effects of behavioural economics remedies. The third part of this paper looks briefly at the implications of these developments. The CMA energy market investigation panel will need to reconsider the *Initial Findings* and *Possible Remedies* in the light of the new Steer. The CMA itself will also need to consider the implications of the new Steer. One avenue of enquiry could usefully be a reconsideration of the nature, evidence and implications of behavioural economics for regulation and competition policy.

## **PART ONE: THE WELL-FUNCTIONING MARKET AND THE ROLE OF OFGEM**

### **2. The Enterprise Act 2002**

9. Market investigation references were provided for by the Enterprise Act 2002. Shortly after his appointment, the CMA Chief Executive spoke about the reasons for the shift in UK merger policy in 2002, from a public interest test to a competition-based test.<sup>6</sup> The same thinking applied to market investigations.

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<sup>6</sup> "For decades UK mergers were assessed on a broad public interest test under the Fair Trading Act 1973 and before it the Monopolies and Restrictive Practices Act 1948. The Fair Trading Act required the authorities to take into account 'all matters which appear to them in the particular circumstances to be relevant'.... In shifting towards a competition-based assessment, successive British governments had also taken on board years of concerns about the lack of transparency and predictability in the public interest test. ... Hence, a decade or so later, the Enterprise Act 2002 established a fully independent and competition-based regime. This has been described as having put an end to 'substantial room for the exercise of political preferences'." Alex Chisholm, Speech delivered at Fordham University School of Law, New York, 11 September 2014, at [www.gov.uk/government/organisations/competition-and-markets-authority](http://www.gov.uk/government/organisations/competition-and-markets-authority)

Under the Fair Trading Act 1973, the Commission<sup>7</sup> could be asked to investigate whether a monopoly situation existed and if so in favour of whom, “whether any steps ... are being taken by that person or those persons for the purpose of exploiting or maintaining the monopoly situation”, and “whether any action or omission on the part of that person or those persons ... operates, or may be expected to operate, against the public interest”. The public interest included “all matters which appear to them in the particular circumstances to be relevant”.

10. The Enterprise Act 2002 swept away the public interest criteria. Section 134(1) provides that “(1) The Commission shall, on a market investigation reference, decide whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services”. Such features would constitute an adverse effect on competition. Section 134(4) provides that, if it finds such an effect, the Commission has to decide whether to take action “for the purpose of remedying, mitigating or preventing the adverse effect” on competition or any detrimental effect on customers. Section 134(5) defines a detrimental effect on customers in terms of higher prices, lower quality, less choice or less innovation.
11. The Commission was given no mandate to look at the broader public interest, or to take action other than to address a specified adverse effect on competition (AEC).

### **3. The Commission’s market investigation *Guidelines* and the nature of competition**

12. The 2002 Act required the CC to “prepare and publish general advice and information about the consideration by it of market investigation references”. In 2003 the CC published its *Guidelines*.<sup>8</sup> These said that “it will be for the Commission to reach its own conclusions as to whether there are any possible adverse effects on competition. In doing so, the Commission sees competition as a process of rivalry between firms or other suppliers ... seeking to win customers’ business over time”. (paras 1.15, 1.16) This is followed by two full paragraphs explaining the nature and beneficial implications of the rivalrous process of competition.
13. The significance of this definition is that it commits the Commission, in reaching its conclusions, to using one of two alternative approaches to (or senses of) the concept of competition. The 2003 *Guidelines* describe these two concepts as follows: “competition, in both its more static sense of price, cost and profit levels and its longer term dynamic sense of experimentation with new ideas, innovation, differentiation and development of products and markets through time”. (para 1.18) The *Guidelines* indicate that the Commission, in its analysis, will look at the impact of structural and conduct features in both senses of competition. But in reaching conclusions on adverse

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<sup>7</sup> This generic term refers to the Monopolies Commission and its various successors the Monopolies and Mergers Commission, the Competition Commission and now the CMA.

<sup>8</sup> *Market Investigation References: Competition Commission Guidelines*, June 2003.

effects, the Commission sees competition as a process of rivalry over time. See (Littlechild April 2014) for more detail.

14. The 2003 *Guidelines* were issued before the Commission had actually undertaken any market investigations, so this was essentially a declaration of intent. In March 2010 the Commission decided to update the *Guidelines* to reflect actual practice in the ten market investigations to date.<sup>9</sup> The letter identifying some issues for review did not include the nature of competition.<sup>10</sup>
15. The revised 2013 *Guidelines* take broadly the same approach as in 2003. There is explicit endorsement of competition as a process, and an emphasis on change rather than on equilibrium.<sup>11</sup> Perhaps the discussion is shorter, terser, more qualified than in 2003. The phrase “over time” is omitted from the initial definition, which perhaps suggests less appreciation that competitive processes take time to work out. However, it is later affirmed that “38. Whatever forms competition takes, the CC considers its effects and expected development over time.”
16. Successive Commission chairmen including the present one have been particularly explicit in their endorsement of the competition-as-process approach.<sup>12</sup> Whether the 2013 *Guidelines* accurately describe the concept of competition that the Commission has actually adopted in its market investigations since 2003 is perhaps debateable: the *Guidelines* provide no documentary evidence. In practice, inquiry panels have developed a concept called the “well-functioning market”.

#### 4. The well-functioning market in Commission Guidelines

17. The CC’s March 2010 letter to stakeholders had a paragraph headed ‘Counterfactual’ that identified three possible benchmarks “against which to assess whether ‘any feature or combination of features’ harms competition”, one of which was the “well-functioning market”.<sup>13</sup> A couple of responses to

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<sup>9</sup> *Review of CC Market Investigation Guidelines*, Letter to Stakeholders, CC, 16 March 2010.

<sup>10</sup> The consultation in April 2011 repeated essentially the same one-sentence definition of competition as in 2003, as did the consultation in June 2012. *Guidelines for Market Investigations: Their role, assessment, remedies and procedures*, Draft for comment, CC, April 2011 (para 4) *Guidelines for Market Investigations: Their role, assessment, remedies and procedures*, CC, June 2012 (para 8)

<sup>11</sup> “10. Competition is a *process of rivalry* as firms *seek to win* customers’ business. It creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible - by *cutting prices, increasing output, improving quality or variety, or introducing new and better products, often through innovation;...*” (italics added) *Guidelines for market investigations: their role, procedures, assessment and remedies*, CC3 (Revised), April 2013. This theme is continued in the next two paragraphs (11 and 12).

<sup>12</sup> For example, “the Austrian School’s view of markets and competition as a process of rivalrous discovery, with continual change and evolution, rather than embodying the concepts of optimality and equilibrium, is more helpful.” David Currie, “The case for the British model of independent regulation 30 years on”, Currie Lecture given to the Cass Business School in London, 21 May 2014, available at [www.gov.uk/government/organisations/competition-and-markets-authority](http://www.gov.uk/government/organisations/competition-and-markets-authority)

<sup>13</sup> “9. The Act does not set out a benchmark ... However, existing [2003] guidelines refer to ‘a fully competitive market’ and the CC has developed the concept of the ‘well-functioning market’ as two possible benchmarks. Another possible benchmark could be a hypothetical counterfactual without the candidate features.”

this and the April 2011 consultation called for clarification. The June 2012 consultation noted that the well-functioning market was a ‘term of art’, “having specific and limited, rather than literal, meanings” (para 6) and explained the CC’s evolving thinking.<sup>14</sup>

18. Three aspects of the June 2012 consultation are of particular interest here: first, the explicit affirmation that perfect competition is not an appropriate benchmark; second, the realisation (or suggestion?) that “a hypothetical counterfactual without the candidate features”, which was previously a third option, was in fact how the CC had defined the well-functioning market in practice; and third, the emphasis that the alternative benchmark had to be “realistic”.

19. The revised 2013 *Guidelines* provide two slightly different definitions.

30. The Act does not specify a theoretical benchmark against which to measure an AEC. In its market investigation reports the CC uses the term ‘a well-functioning market’ in the sense, generally, of a market without the features causing the AEC, rather than to denote an idealized, perfectly competitive market.

320. In the absence of a statutory benchmark, the CC defines such a benchmark as ‘a well-functioning market’ (see paragraph 30) – i.e. one that displays the beneficial aspects of competition as set out in paragraphs 10 to 12 but not an idealized perfectly competitive market.

20. Both definitions retain the affirmation that an idealized perfectly competitive market is not an appropriate benchmark.<sup>15</sup> They differ insofar as the first defines the well-functioning market as one without the features causing the AEC, the second defines it in terms of an intriguing new concept of “the beneficial aspects of competition”. Perhaps significantly, neither definition retains the requirement that the well-functioning market should be realistic.

21. A well-functioning market is not a standard or well-defined term in economics. One source suggests that it is a market without market failures and in particular without any special public interest objectives.<sup>16</sup> A recent paper

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<sup>14</sup> “84. The CC recognizes that the theoretical benchmark against which to measure an AEC can never be a ‘perfectly competitive’ market. In past market investigation reports the CC has used the term ‘a well-functioning market’ in the limited sense, generally, of a market without the features causing the AEC.” “311. ... the CC recognizes that it is generally unrealistic to seek a theoretical measure of the functioning of a ‘perfect’ market. In identifying some features or combination of features of the market that may give rise to an AEC the CC will find a benchmark against which to determine how the market is performing and how it could be more competitive. In previous cases, the CC has defined such a benchmark as a ‘well-functioning market’. The benchmark will generally be the market envisioned without the features. But it can vary and there may sometimes be reasons to depart from that general concept. In these circumstances, the CC has to find a realistic alternative benchmark for the market in question.”

<sup>15</sup> The cited sentence in para 320 is followed by a footnote indicating that the Competition Appeal Tribunal (CAT) endorsed this view.

<sup>16</sup> “Well-functioning competitive markets are characterized by several important attributes”, viz ease of market entry and exit, absence of significant market power, widespread availability of information, absence of market externalities and achievement of public interest objectives. On the last attribute it says “When the market achieves its goals of efficiency, innovation and consumer protection, it will at the same time achieve any special public interest objectives as well. There are no special public interest objectives to satisfy (e.g. universal coverage) that go beyond the capabilities of a well-functioning

written in the retail energy market context (from an equilibrium perspective) finds the term problematic and argues that, paradoxically, a well-functioning market with some fixed costs needs a proportion of customers with behavioural bias.<sup>17</sup> One therefore has to examine the various Commission market investigations to see how they interpret the concept of a well-functioning market in practice.

## 5. The well-functioning market in Commission reports

22. Table 1 shows that there were 11 market investigations before the 2013 *Guidelines* were published and 5 after that. In addition, 2 ongoing market investigations instigated under the CMA regime have reached Provisional Findings stage, making a total of 18 market investigations to date.

[insert Table 1 about here]

23. As explained earlier (Littlechild April 2014), not all investigations used the concept of a ‘well-functioning market’, where it was used it was not clearly or consistently defined, and a few investigations got into difficulties in tracing the implications of the definition. The present paper explores these ideas more precisely.

24. The term ‘well-functioning market’ was not used in the first two market investigations.<sup>18</sup> It was first used just once, in the *Provisional Findings* of the *Home credit* investigation (para 8.4) and three times in the *Final Report*, along with - and apparently synonymously with - the term ‘effectively-functioning’. It was then used in all the subsequent reports except the last report (*Movies*) to be published before the 2013 *Guidelines*.<sup>19</sup>

25. In the 12 final reports that use the term ‘well-functioning market’, the extent of usage varied greatly: less than ten times in five reports, 10 to 20 times in four reports, between 21 and 31 times in two reports, and no less than 65 times in one exceptional report (*ROSCOs*). It is also used, on average, twice as

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market.” William H Melody (former Chief Economist at the US Federal Communications Commission), *Liberalising Telecommunications Markets: A Framework for Assessment*, Policy Primer Papers #3, ICT Governance for Poverty Reduction, IDRC Contract 102450-007, Learning Incentives on Reforms for Network Economies, August 2006.

<sup>17</sup> “... if the market displays the features normally associated with a well-functioning market, the equilibrium market structure is monopoly. Monopoly markets are not usually regarded as well functioning....” (p 170) “... it may paradoxically be the very departure from the rational behaviour that we associate with well-functioning markets that enables this market to sustain more than one firm. This in turn means that intervening to remove behavioural biases in the hope of creating a better functioning market might be not only futile, but self-defeating.” (p 176) Morton Hviid and Catherine Waddams Price, “Well-functioning markets in retail energy”, *European Competition Journal*, 10 (1) April 2014, 167-179

<sup>18</sup> *Store cards* found higher prices and less choice “than would be expected in a competitive market” (para 26). *Domestic LPG* found that certain features of the market adversely affected competition, and increased costs and inconvenience to customers. It identified no explicit benchmark other than, by implication, a market without those features.

<sup>19</sup> The *Provisional Findings of Private Healthcare* include one mention of the term. The *Final Report* omits that but includes one mention of another party’s use of the term. The *Provisional Findings of Private Healthcare remittal* mention it twice.



frequently in the Final Reports as in the Provisional Reports (or three times as frequently if the exceptional *ROSCOs* case is included in the comparison).

26. The 2013 *Guidelines* say that the term is used “in the sense, generally, of a market without the features causing the AEC”. This is true insofar as almost all of the reports that use the term generally do so in the following sense: a market characterised by the absence of feature A would be characterised by lower prices, higher quality, more choice or more innovation.<sup>20</sup>
27. As thus formulated, the essence of the well-functioning market benchmark is that it is *relative*. It is not claimed that in the absence of feature A, the market actually would be well-functioning or in some sense fully competitive. It is simply argued that the market would be *better* functioning and hence would bring more of the benefits associated with competition. The reports could therefore have used the phrase “in a better-functioning market” (were it not such an awkward term) or simply “in a more competitive market”.
28. Of the 15 reports that use the term ‘well-functioning market’, 11 of them (including the *Retail banking Provisional Report*) use it in this relative sense – what we may now call the ‘conventional’ sense. Used thus, it seems generally not to have caused problems.<sup>21</sup> Furthermore, the approaches in the 3 reports that did not use the term seem to be consistent with this ‘relative’ approach.
29. In contrast to this now ‘conventional’ approach, two reports have taken the concept of a well-functioning market literally, as an absolute entity that needs to be described explicitly, rather than as a relative concept. In both of these cases the Commission’s ‘unconventional’ approach got it into difficulties.
30. The first and most serious problem arose with the *ROSCOs* case. The *Provisional Findings* contained only 3 references, of a conventional nature. But in the *Final Report* the number of references leaped to 65. The Commission explained that “The reason for explicitly identifying a hypothetical well-functioning market was because it was not obvious what a competitive market would look like, for example because of the high level of public financial support and regulation in the rail industry.” (para 8.4) Problems arose because of the unclear and disputed nature of this hypothetical

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<sup>20</sup> Sometimes the list of consequences is extended beyond those specified in the Act, for example to more customer switching (*Personal current accounts NI*), more responsiveness to customers (*BAA airports*) and more responsiveness to shareholders (*Audit Services*).

<sup>21</sup> There were occasional hiccups when the concept was pushed too far (Littlechild April 2014, 183-6). Thus, in *Classified Directory Advertising* the Commission is sure that prices would be lower in a well-functioning market. But it is not sure whether they would rise less fast than inflation (which presumably depends on the particular facts of the situation, and how that market actually works, not on a general qualitative proposition about competition). In *Audit Services* the well-functioning market is defined as the market without the features causing the AEC, and one of those features is identified as “audit is in part an experience good”. One party then asked what would be the nature of a well-functioning audit market in which audit was not an experience good, if being an experience good was intrinsic to the concept of audit? The CC commented “8.7 ... We note that certain features may be intrinsic to some extent and so while the relevant market cannot realistically be envisioned with-out them, we can nevertheless consider what effect these have in shaping competition.”

market.<sup>22</sup> In addition, its equilibrium character seems inconsistent with the *Guidelines*.<sup>23</sup>

31. A second and different unconventional approach was used in *Private Motor Insurance*, where “we considered a benchmark ‘well-functioning market’ to be a market which delivered consumers’ legal entitlements in an efficient way”. (para 30) When the Commission found what it regarded as inefficiencies (such as excessive transactional costs arising from insurers and brokers competing to earn a rent from their control of non-fault claims), it considered this inconsistent with a well-functioning market. It then ran into trouble when it came to wide Most-Favoured Nation (MFN) clauses in contracts. It considered that these clauses had an adverse effect on competition. However, “We found it difficult to determine what the outcomes (eg on commission fees and PMI premiums) were of this feature against the benchmark of a well-functioning market (ie one that did not involve wide MFNs).” (para 8.123)
32. Why the Commission adopted this quite different benchmark in *Private Motor Insurance* is unclear: no reason was given. Precisely what the Commission meant by efficiency, whether the Commission is normally in a position to identify which arrangements are less efficient than others, and whether this is always equivalent to identifying practices that have an adverse effect on competition, are surely debateable questions. It does, however, seem to be an approach again based on competition-as-equilibrium rather than competition-as-process.

## **6. An organisational rationale for the well-functioning market?**

33. Is it possible that the “well-functioning market” has been invented and adopted by successive market investigation inquiry groups precisely because (like ‘effective competition’) it has no well-defined economic meaning? Consider how such investigations function. The Commission appoints an inquiry group of 5 or 6 independent panel members for each investigation.<sup>24</sup> They come from many different backgrounds, and most are not economists. They may have

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<sup>22</sup> This hypothetical well-functioning market was described as one “where competition is as effective as possible” but “not necessarily a market that could be created in practice”, which seems problematic in itself. Then one member of the group disagreed as to what this well-functioning market would comprise – he argued that it should include a market for used as well as new rolling stock, and on that basis proposed an additional remedy that the other members rejected. Littlechild (April 2014), *op cit* pp 184-5

<sup>23</sup> At one point in describing how this well-functioning market would work, it was explicitly stated that “This process of competition would result in a market equilibrium”. (para 4.30) Thus, in contrast to the Commission’s stated emphasis in the 2003 *Guidelines* on competition-as-process, and later its explicit affirmation in 2013 that the well-functioning market would not be couched in terms of perfect competition, the benchmark prices that the Commission would expect to find in a competitive market were characterised using the concept of competition-as-equilibrium. Admittedly, “equilibrium” does not necessarily imply a perfectly competitive equilibrium but the report made no attempt to draw a distinction. Ironically, the *ROSCOs Provisional Report* refers to “a well-functioning market – in other words, a market in which the process of rivalry operates effectively”. (para 8.7)

<sup>24</sup> These members, appointed by the Department of Business, Innovation and Skills, are “persons of high repute and professionalism, who could be expected to understand their obligations of open-mindedness and be sincere and genuine in their efforts to achieve it”. *HCA v CMA* [2015] EWCA Civ 492, para 51.

served on other CMA cases but the members of each inquiry group will not previously have worked together as a group. A total of 90 members served on these 18 market investigations. 37 members served on only one investigation, 20 members on two, 3 members on three and 1 member on four investigations. This means that establishing an inquiry group view is not necessarily straightforward.

34. The group may feel that market features A, B, C have an adverse impact, and the concept of the well-functioning market may help to organise this. Specifically, they may feel that (1) in the absence of features A, B, C the market would function better, would be more competitive; and (2) a more competitive market would be characterised by lower prices, ... etc. In any actual investigation there is room for discussion about the first proposition – for example, as to which features A, B, C have potentially adverse effects, and which of the adverse effects specified in the Act they are most likely to cause.
35. However, an intriguing feature of the second proposition is that it is consistent with both theories of competition: as equilibrium and as process. It is something on which all economists – and, importantly, non-economists - can generally agree. A problem only arises if this simple intuitive concept of a well-functioning market, as an organisational device for facilitating consensus between (mainly) non-economists, is pushed too far – if it is defined in too much detail, or expected to deliver unduly precise economic predictions. Or, as we shall see, if it stretches or distorts the representation of a competitive market.<sup>25</sup>

## 7. The well-functioning market in the Energy market investigation

36. In the *Energy* market investigation, the *Provisional Findings* (10 July 2015) mention the well-functioning market 17 times. (If the Final Report has double that number, which is par for the course excluding *ROSCOs*, *Energy* will have the second-highest number of mentions of the well-functioning market of any market investigation to date, which may be worth pondering.) The investigation covers several aspects of the energy market. A small handful of the references relate to more technical issues, and are consistent with both equilibrium and process concepts of competition.<sup>26</sup> About half the total number of references to the term in the *Provisional Findings* use it in the ‘conventional’ relative sense, generally posing the question whether a well-functioning market would be characterised by lower prices (and answering Yes).<sup>27</sup>

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<sup>25</sup> A reviewer suggests that it would be possible and helpful to consider also what a badly functioning market would mean, and to identify thresholds thereof for each market, possibly with an intermediate zone where one might take one view or the other depending largely on beliefs about the efficacy of remedies.

<sup>26</sup> Thus, “155. ... Accurate and timely settlement is fundamental to well-functioning retail energy markets”, and “4.82 As a rule of thumb, in a well-functioning market, power flows to higher-priced zones.”

<sup>27</sup> The use of the term in respect to a capacity market is a notable exception. “5.136 The theory of a well-functioning competitive energy-only electricity market is that generators will fully recover sunk capital costs (e.g. the costs to build generation capacity) at very occasional peak times – once every 20 years, perhaps.” This is an explicit definition, reflecting competition-as-equilibrium writ large.

37. In contrast, when it comes to the *retail* energy market, the Summary defines a well-functioning domestic retail market explicitly, as an absolute rather than relative concept.

“85. We would expect competition in a well-functioning retail market to be largely on price, with competitive pressures bearing down on elements of the overall costs of energy supply, in particular suppliers’ gross margin (ie the combination of indirect costs and net profit). ...86. We would expect competitive pressures to be such that customer service meets certain minimum required standards, notably accurate billing. We would expect some degree of innovation, around tariff design, convenience and services such as advice on improving energy efficiency....”

Alongside this, there are predictions as to how competition in such a market would evolve in future, after the roll-out of smart meters. Interestingly, the main text refers, not to a well-functioning market, but to effective competition.<sup>28</sup> So the term itself is not critical. Regardless of the phrasing, however, the benchmark is an explicit description of a competitive market as an absolute concept rather than the ‘conventional’ relative concept.

38. The well-functioning retail energy market is presented as a prediction of what the Commission would expect the market to look like, given its assumptions about customer behaviour, about what would be most important to customers (*viz* price). Since the market is then observed not to look like that, the *Provisional Findings* interpret this difference as evidence of “weak customer engagement”.<sup>29</sup> In effect, customers are not behaving as they would if they were more rational.

39. There is an analogous approach in the analysis of the microbusiness retail market. A well-functioning market is defined in absolute terms, reflecting what a competitive market would be expected to look like, given the Commission’s assumption about how microbusiness customers would behave. Then the actual market is found wanting. Specifically, the *Provisional Findings* predict that a well-functioning market would be characterised by customers not spending much time on default tariffs, but this behaviour is not observed.<sup>30</sup> Instead of concluding that its understanding of customers is incomplete, the Commission again perceives this as evidence that customers are not acting as they would in a well-functioning market, so again competition is not working effectively.<sup>31</sup>

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<sup>28</sup> “the sorts of outcome we would expect effective competition in retail markets to lead to” (para 7.3), and “the outcomes we would expect if competition is effective in energy supply markets” (para 7.43).

<sup>29</sup> E.g. “117. Our finding of material potential savings that are persistent over time, available to a significant number of domestic customers and that go unexploited provides evidence of weak customer engagement in the domestic retail markets for electricity and gas in Great Britain.”

<sup>30</sup> “9.86 In a well-functioning market, we would expect to see evidence that customers only stayed on these high price tariffs for transitory periods (eg when setting up a new business, changing premises, or changing supplier). ... However, the evidence summarised below shows that many customers who use these tariffs stay on them for a substantial period of time.”

<sup>31</sup> “9.36 ... prices are generally significantly higher on these default tariffs. We therefore view spending more than transitory periods on them as a sign of a possible lack of engagement. 9.96 ... we do not believe that competition can be working effectively to constrain these tariffs, given that some microbusiness customers do remain on them for a considerable period of time despite significantly cheaper tariffs being available.”

## 8. Origins of the CMA's well-functioning retail energy market

40. Where does the CMA's 'unconventional' well-functioning retail energy market come from? The definition in its *Provisional Findings* of July 2015 derives from its July 2014 *Statement of Issues*<sup>32</sup>, which sets out certain "key characteristics" of energy markets. This says "17. ... The benchmark against which we will assess an AEC is that of a 'well-functioning market', that is, one that works well for customers. ... Given the above characteristics, a well-functioning market will generally be expected to require some form of regulatory intervention." Neither of these last two propositions – about working well for customers and requiring regulatory intervention – reflects the way that the 2013 *Guidelines* actually define a well-functioning market. So, again, where did it come from?
41. The CMA's July 2014 *Statement of Issues* followed directly on Ofgem's referral of the energy market to the CMA on 26 June 2014. Both were informed by the *State of the Market Assessment* carried out by Ofgem working closely with the OFT and the CMA (see later) and published by Ofgem on 27 March 2014. This in turn was prepared within the *Assessment Framework* of 19 December 2013, similarly developed by Ofgem with OFT and CMA.<sup>33</sup>
42. This *Assessment Framework* consisted of three stages, of which the first was "3.2 ... A description of a well-functioning market, and how competition should work to deliver desired outcomes". It continues "3.4 ... In describing this well-functioning market, we recognise that energy is an essential service and that there are certain groups of consumers who are not able to engage in the market as much as others." It describes in some detail "3.6 ... some of the characteristics we would expect to see in a well-functioning energy market in the short and longer term". It then considers "features in the market ... that could indicate it is not functioning well ... The range of metrics ... over time could also change to reflect new regulatory interventions ...".
43. The *Assessment Framework* contains a paragraph that appears to summarise the characteristics of this well-functioning market.
- Ofgem's vision of a successful energy market is one where suppliers, including a range of new entrants, compete over time to make better offers to consumers and that empowered and engaged consumers incentivise suppliers to compete with each other to deliver efficient and innovative products and services. In this market, there would be high levels of customer service, significant switching in response to price changes, and different supplier strategies around pricing and customer acquisition. There would be competitive pressure constraining the level of prices and profits and driving suppliers to reduce their costs. Ofgem's view would also recognise that energy is an essential service, and that certain groups of consumers that are not able to engage in the market fully are not unduly disadvantaged. (Executive Summary p 4)

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<sup>32</sup> CMA, *Energy Market Investigation, Statement of issues*, 24 July 2014

<sup>33</sup> Ofgem, OFT & CMA, *State of the Market report – assessment framework*, 19 December 2013. Ofgem, OFT & CMA, *State of the Market Assessment*, 27 March 2014

44. The context for this is an explanation that “Ofgem has previously made clear that in its view the market is not working as well as it should. To address these concerns it has introduced its Retail Market Review (RMR) reforms aimed at making the market simpler, clearer and fairer for consumers.”<sup>34</sup> “In considering the features that we should look at we have followed a standard typology, based on Competition Commission (CC) guidelines, for looking at potential sources of harm under a number of broad categories.” And on weak customer response, in particular, “We will update the evidence Ofgem considered in the RMR.”
45. The CMA’s unconventional definition of a well-functioning retail energy market thus originates with “Ofgem’s vision” set out in the December 2013 *Assessment Framework*. This vision reflects Ofgem’s 2011 RMR approach, which in turn was a continuation and development of its 2008 *Probe Initial findings*.<sup>35</sup>

## 9. A well-functioning market with efficient costs

46. The *Provisional Findings* pose the ‘conventional’ question “whether the average prices paid by domestic customers and microbusinesses have been above the levels that we would expect to see in a well-functioning competitive market”. They then go on to pose the less conventional question: “what price levels would we expect to have seen in a competitive market?” (para 2.161) They specify that the comparator is “a well-functioning market in which costs and profits are competed down to efficient levels”. (10.2)
47. The *Provisional Findings* proceed to calculate these “efficient levels”, viz  
 “the level of prices that suppliers would have required in order to cover reasonably efficient levels of costs and earn a fair rate of return on capital employed. We term this the ‘competitive benchmark’ on the basis that, had competition functioned more effectively over the period, we would expect prices to have been driven down to this level. As such we consider that this provides an illustration of price levels in a better functioning, but not necessarily perfectly competitive, market.” (para 10.43)
- Despite the hopeful protestation at the end, this is a thorough-going competition-as-equilibrium concept, perfect competition in all but name.
48. Is this a standard Commission approach? The 2003 *Guidelines* briefly mentioned the possibility of calculating excess costs relative to those that would obtain in a well-functioning market.<sup>36</sup> At this point, of course, there had been no market investigations, so this was just a guess at what the Commission *might* do in this respect. The 2013 *Guidelines* were rather more dismissive, suggesting that practical considerations might prevent it.<sup>37</sup>

<sup>34</sup> Ofgem, *RMR Review – Findings and initial proposals*, 21 March 2011

<sup>35</sup> Ofgem, *Energy Supply Probe - Initial Findings Report*, Ref 140/08, 6 October 2008

<sup>36</sup> “3.83 Low profits, on the other hand, may conceal ineffective competition if firms with market power are able to operate with higher costs than would be sustainable with keener rivalry in the market. Therefore the Commission may also look at data on costs and compare actual costs with efficient costs in addition to looking at profits.”

<sup>37</sup> “125. ... In some cases, the CC may be able to compare actual costs with efficient costs when looking at the level of profitability achieved by firms but this may not always be practical.”

49. In fact, however, the Commission has never previously compared actual costs with efficient costs, nor mentioned the issue of practicality. Only a couple of early market investigations (*Domestic LPG* and *Personal bank accounts NI*) found it worthwhile even to mention the possibility that market power might be reflected in higher and/or inefficient costs, and then only by a one-sentence cross-reference to the *Guidelines*. As Table 1 indicates, none of the investigations actually calculated such inefficiencies, or even discussed them.<sup>38</sup>
50. In contrast, the *Energy* investigation not only calculates such allegedly efficient costs, it also claims that the difference between these efficient costs and actual costs is a measure of the exploitation of market power, additional to that of excess profit. Indeed, it seems that excess costs may exceed in magnitude the extent of alleged excess profits (although the *Provisional Findings* calculations are obscure on this point, presumably intentionally so). In other words, adding in ‘excess costs’ may roughly double the alleged overcharging of customers, clearly not a negligible impact.
51. Yet, elsewhere in the same investigation, the *Possible Remedies* discussion of a possible price control remedy explicitly rejects an approach that relates competitive prices to efficient costs.
92. ... The standard approach to price controls in network industries is for the regulator to aim to set prices at what it assesses to be a competitive level, based on a suitable measure of efficiently incurred costs. We consider, however, that to set the default tariffs in this way could have severe repercussions for competition, ...
52. As a statement of “the standard approach to price controls in network industries” such as energy and water, the first sentence is incorrect: regulators do not aim or claim to set such prices at “a competitive level” and do not claim that prices “based on a suitable measure of efficiently incurred costs” constitute a “competitive level”. More interesting is the second sentence: why exactly does the CMA *Possible Remedies* paper consider that setting prices at a competitive level could have severe repercussions for competition? It is because “full price regulation ... would remove any prospect of reaping the benefits from the competitive process both now and in the future.” (para 34) In other words, prices set at an alleged “competitive level” based on “efficiently incurred costs” would reflect the “idealized perfectly competitive market” that the CMA *Guidelines* state will not be used to define a well-functioning market. They would be inconsistent with the “process of rivalry” that obtains in the real world.
53. Put another way, the *Provisional Findings* paper takes the view that, at an arbitrary point in time, the market ought to look something like the (hypothetical) equilibrium outcome of an (idealised) competitive process. In contrast, the *Possible Remedies* paper recognises that actual competitive

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<sup>38</sup> Sometimes there is reference to efficient costs, but the emphasis is on profits or margins. E.g. “Even in some reasonably well-functioning markets, some prices will exceed efficient costs, often by quite a large margin and for some time.” (*Home Credit* para 7.39)

market processes are not like this, and that trying to impose a (hypothetical) equilibrium outcome would stifle rather than stimulate that competitive process.

54. This inconsistency in the CMA’s approach might give the impression that its choice of a perfect competition approach to calculate alleged overcharging of customers is simply a matter of expediency. Its proposition that weak customer response and unilateral supplier market power have an adverse effect on competition would be undermined if the conventional profit calculations do not confirm the excessive charging of customers. The CMA’s approach here might seem to imply that boosting the calculated overcharging takes precedence over consistency of principle.

## 10. The origin of the well-functioning market with efficient levels of cost

55. The emphasis on efficient levels of cost in the *Energy* market investigation is so marked, and so inconsistent with previous Commission practice (and inconsistent with present CMA practice in the *Retail Banking* investigation), that it begs the question where it originated. The *Provisional Findings* of July 2015 reflect discussion and analysis in a CMA Working Paper of March 2015.<sup>39</sup> It is there claimed that “77. In a well-functioning market, all things being equal, ... over time the gap between the highest and lowest cost suppliers should converge”. This claim in turn derives from the *State of the Market Assessment*<sup>40</sup> and the *Assessment Framework*.<sup>41</sup> Although the argument is attributed to both Ofgem’s *Probe Initial Findings* (2008) and an IPPR paper, the latter simply refers back to the same Ofgem *Probe Initial Findings*.<sup>42</sup>

56. Unfortunately, as argued elsewhere, the analysis of efficient cost in the *State of the Market Assessment* “is at best incomplete, and at worst misleading, in

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<sup>39</sup> *Profitability of retail energy supply: profit margin analysis*, CMA Working Paper, 16 March 2015.

<sup>40</sup> “6.35 ... We would expect costs to be driven down towards efficient levels over time after competition is introduced in a well-functioning market.” “6.36. In 2008, Ofgem noted a concern that the supplier with the highest operating costs per account was spending 90 per cent more on each account than the supplier with the lowest costs. [footnote reference to Ofgem, *Energy Supply Probe – Summary of Initial Findings*, 6 October 2008] ... . In 2012, the IPPR noted that the differential appeared to have widened, indicating that competitive pressure was failing to drive convergence in supplier costs, as should be expected according to economic theory.” [footnote reference to IPPR, *The True Cost of Energy*, 30 April 2012, Section 2.3.] “6.37 ... The variation in indirect costs among the major suppliers has remained significant over time with little convergence in costs, as one might expect if competition were driving down costs to the efficient level over time.”

<sup>41</sup> “4.25 We propose a fourth strand of work to examine patterns of costs over time and between firms. This may inform our view of whether competition is functioning effectively because we would expect vigorous competition between firms to lead to costs being driven down over time to efficient levels.”

<sup>42</sup> “The IPPR in turn referred back to the *Initial Findings* of Ofgem’s Probe (October 2008, para 7.86). Ofgem there noted ‘a wide range of operating costs per account, with the cost per account of the highest cost supplier around 90 per cent higher than those of the lowest’. It said ‘this evidence is not consistent with an effectively competitive market, where we would have expected such material cost differences to have been competed away’.” Stephen Littlechild, *Operating cost variations in a competitive market*, 20 March [misdated February] 2015, published under Initial Submissions on CMA website 24 March 2015.



three respects”.<sup>43</sup> And while Ofgem and the CMA have published estimates of profits and margins in the energy sector, neither Ofgem nor the CMA has provided any theoretical reasoning or empirical evidence as to what level of convergence to “efficient costs” obtains in any other market, or would be consistent with a competitive or uncompetitive market.

## 11. The influence of Ofgem

57. The joint *State of the market report – Assessment framework* of 19 December 2013 and the *State of the Market Assessment* of 27 March 2014 were thus essentially Ofgem documents: that body had the main responsibility and the energy expertise. The CMA was still in the process of being created. (It was legally established on 1 October 2013 and went live on 1 April 2014.) The two *Assessment* documents put into *Guidelines* typology the potential sources of harm and potentially adverse effects on competition that reflected Ofgem’s long-standing concerns. Perhaps not surprisingly, these did not include regulatory interventions: a fox invited to assess the security of the chicken farm might not think to mention the couple of access holes that it had made in the fencing.
58. Coincident with the publication of the *State of the Market Assessment* on 27 March, Ofgem consulted on its proposal to refer the market to the CMA. It confirmed this decision on 26 June. On 23 July the CMA’s subsequent *Statement of Issues* indicated that its “principal evidence” comprised four Ofgem reports plus “academic research”.<sup>44</sup> Perhaps the former led it to the view that “a well-functioning market will generally be expected to require some form of regulatory intervention” (para 17) while the latter led it to add regulatory interventions as a possible element of a theory of harm.
59. The CMA seems to have taken Ofgem’s analysis and perceived the regulator as simply having chosen the wrong instrument to deal with a commonly agreed problem. Hence the *Possible Remedies* are led to consider other interventions, some more drastic, to achieve the same policy goal. Not surprisingly, perhaps, Ofgem “strongly agreed” with the CMA’s analysis of the retail market.<sup>45</sup>
60. The fact that the *Provisional Findings* are critical of Ofgem’s ‘simple tariffs’ restrictions and suggest their removal as a possible remedy is not inconsistent

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<sup>43</sup> “... economic theory does not imply, as claimed, that operating costs of suppliers in a competitive market will converge over time; as it happens, however, the evidence presented in the *Assessment* suggests that operating costs of the major suppliers *did* converge over the period 2009 – 2012, arguably by more than the “little convergence” referred to in the *Assessment*; the extent of cost differences between major suppliers, and the extent of convergence, reflect the impact of state ownership of one major supplier as well as the extent of competition: after removing that comparator the extent of cost difference is markedly less than indicated in the *Assessment* and the convergence over time is markedly greater than indicated there”. Littlechild (2015), *op cit*.

<sup>44</sup> CMA *Statement of Issues* Fn 3. The four Ofgem sources were *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, 26 June 2014; *State of the Market Assessment* 27 March 2014 (Ofgem with OFT and CMA); *Retail Market Review* 2010; and *Liquidity proposals for the Great Britain wholesale market* 2010.

<sup>45</sup> Ofgem, *Response to the CMA’s Provisional Findings and Possible Remedies*, 5 August 2015, p 1.

with this argument. Shortly after Ofgem's then-new chief executive referred the market to the CMA he declared that the four tariff rule was not a long-term solution. More recently, Ofgem has proposed to move away from detailed rules to principles-based regulation.<sup>46</sup>

61. The CMA is restrained about Ofgem's various interventions. Discussion of regulation accounts for only about a dozen of the 137 pages in the two chapters on the domestic retail market. There is relatively limited analysis of the effects of the interventions. The non-discrimination condition and the direct selling marketing condition are not pursued. Concern about RMR focuses on the 'simple tariffs' aspect, and its adverse effect on product variety and innovation. This adverse effect is important, but not the only one. The CMA has not sought to quantify or even assess in any detail the impact that the regulatory interventions presumably had - and are still having - on engagement in the market by different types of customers, on the presentation of information to customers, and on prices, profits and price differentials, even though the impact must be substantial.<sup>47</sup> Although the CMA 2013 *Guidelines* stress that the Commission always considers how competition in a market might evolve over time,<sup>48</sup> the *Provisional Findings* do not consider how competition in the energy market might evolve if unrestricted by these interventions, particularly with respect to the other claimed features of weak customer response and market power.
62. The CMA's rather gentle treatment of Ofgem's regulatory interventions, and Ofgem's enthusiastic support for the CMA's analysis, stand in contrast with the CC's investigation of *BAA Airports*. The CC listed and critically discussed at length various respects in which it considered that regulation by the Civil Aviation Authority (CAA) had had adverse effects. The CAA responded robustly. The CC was led to specify what it considered "a well functioning system of regulation" would provide. (para 6.55)
63. The CMA's procedures are designed to ensure an independent approach.<sup>49</sup> The CMA and Ofgem have no doubt followed standard procedures since Ofgem

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<sup>46</sup> Ofgem, *The future of retail market regulation*, 18 December 2015.

<sup>47</sup> Average customer switching fell from 20% in year ending September 2008 to 10% in year ending September 2013 and was still under 13% in year ending December 2015. Source: Cornwall Energy calculations. Domestic supply EBIT for the six large energy firms combined rose from £110m in FY2007 and -£6m in FY2008 to £1,200m in FY2012 and £1,100m in FY2013. Source: *Profitability of retail energy supply: profit margin analysis*, CMA Discussion paper 16 March 2015, Table 5

<sup>48</sup> "38. Whatever forms competition takes, the CC considers its effects and expected development over time. Although there may be circumstances in which analysis can be conducted only on the basis of the current state of the market, the CC always considers how a market may evolve."

<sup>49</sup> The CMA explains that panel members are independent of the CMA Board, and also of any other body that may be responsible for making a market investigation reference (such as, in the case of the Energy investigation, Ofgem). Accordingly, Ofgem's submissions have been (and continue to be) treated on the same footing as submissions received from other parties. Inquiry groups of panel members are responsible for providing strategic direction, weighing the evidence before them, considering the arguments of all parties, and directing and assessing the analysis produced by the staff team. They are also responsible for making final decisions on whether or not there are features of a market that give rise to an adverse effect on competition and if so the remedies to be applied. Such decisions are taken on the basis of all relevant evidence before the inquiry group.

made the reference.<sup>50</sup> But one is left wondering whether the procedures before that, particularly the joint development of the assessment framework, gave Ofgem an undue influence on the approach adopted by the CMA (and, for that matter, conversely). More on this below.

## 12. The well-functioning market and the public interest

64. As noted earlier, the Enterprise Act 2002 provided for the Commission to focus on competition issues, and removed the provision for the Commission to consider or take action with respect to the public interest. Successive market investigations often found it useful to organise their thinking about adverse effects on competition via the concept of a well-functioning market. The 2013 *Guidelines* defined this concept in two different ways, one of which was a “market that displays the beneficial aspects of competition”. The significance of this phrase is not clear. Does it suggest that the Commission should distinguish between beneficial/desired and harmful/undesired aspects or types of competition, and take steps to promote the former and prevent the latter? It seems to stand in contrast to the emphasis in the June 2012 consultation paper on a “realistic” benchmark.
65. Would it be surprising if inquiry groups sometimes felt during their investigations, or were encouraged to believe, that certain aspects or types of competition were beneficial and desirable but that others were not? That it would be appropriate to encourage the former and/or discourage the latter? Suppose that the benchmark well-functioning market were defined to include the former features or types. Would an inquiry group not have given itself, in effect, a remit to promote the public interest as it saw it, and to take action for the purpose of remedying, mitigating or preventing any adverse effects on this public interest?
66. Far fetched? Or is it? The definition of the well-functioning market in the retail part of the *Energy* market investigation is different from that in any previous CMA market investigation, and can be clearly traced back to “Ofgem’s vision of a successful market” in the December 2013 *Assessment Framework*. This is “a market that works well for customers”, one that delivers “desired outcomes”. In this market there are new entrants, empowered and engaged consumers, innovative products, high levels of customer service, significant switching in response to price changes, competitive pressures driving price, profits and costs to efficient levels, and those groups of consumers not able to engage in the market fully are not unduly disadvantaged. Competition is then one mechanism, along with “some form of regulatory intervention”, for delivering those desired outcomes.
67. So all is for the best in this best of all possible worlds. Such a well-functioning market would assuage public concern. But is it a realistic assessment of what a competitive market would or could actually look like? Or is it, instead, a vision of a theoretical ideal, or a type of competition that it is argued would be

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<sup>50</sup> This includes using the work done by the referring body (Ofgem) as a starting point, per the 2013 *Guidelines* para 165.

in the public interest to secure? In short, how does the Ofgem/CMA concept of a well-functioning energy market fit with the Enterprise Act 2002 obligation on the CMA to look at competition issues but not at any broader concept of the public interest?

### 13. Retail electricity market regulation in the European Union

68. To assist in evaluating this question, consider what might be the first public ‘vision’ of a well-functioning competitive retail energy market, as expressed in the statements of European regulatory bodies with whom Ofgem has been working. The Council of European Energy Regulators (CEER) was set up in 2000 by the energy regulators themselves. Its stated aim was to facilitate the creation of a single competitive, efficient and sustainable EU internal energy market. Ofgem has been a leading member of CEER since the beginning, and Sir John (later Lord) Mogg, the chairman of Ofgem’s governing body from 2003 to 2014, has been the president of CEER since 2003.
69. In January 2012 CEER proposed to develop “a customer vision of energy markets”.<sup>51</sup> In September 2014 ACER and CEER produced their *Energy Regulation: a Bridge to 2025*. One of five proposed key objectives for the internal energy market in 2025 was “46 ... well-functioning retail energy markets at least at national level which should deliver reliable, affordable and simple-to-use services to protect and empower customers”.<sup>52</sup> This strongly influential strategy paper led in February 2015 to the European Commission acknowledging these concepts as part of its Energy Union Framework Strategy. In October 2015 CEER published a “strategic high-level paper” on well-functioning retail energy markets.<sup>53</sup> This “begins a process of refinement to develop common criteria to assess better what a well-functioning retail market should look like and to provide a framework for analysing its evolution and performance”.
70. Of particular relevance to the present paper, and to the CMA energy market investigation, is that this recent CEER position paper explicitly distinguishes between a competitive market and a well-functioning market.<sup>54</sup> That is, the concept of a well-functioning retail energy market as developed and advocated by CEER is *not* a competitive market as normally understood in the UK. Rather, it is a *combination* of a competitive market and various regulatory measures intended to deliver desired outcomes that are *different from* those

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<sup>51</sup> CEER 2012 *Work Programme*, Ref: C11-WPDC-22-06, 24 January 2012.

<sup>52</sup> ACER, PR-09-14, CEER, PR-14-07, 23 September 2014. The *Conclusions Paper* of 19 September 2014 followed *Pre-consultation* and *Consultation Papers* on 6 November 2013 and 29 April 2014, respectively.

<sup>53</sup> CEER *Position paper on well-functioning retail energy markets*, Ref C15-SC-36-03, 14 Oct 2015

<sup>54</sup> “... given the essential nature of energy as a service, competition is necessary - but may not be sufficient - for the delivery of broader consumer outcomes. Well-functioning markets need to benefit society as a whole, particularly by ensuring that vulnerable consumers are not disadvantaged or overlooked.” (p 7) “Our position starts from the perspective of ‘well-functioning’ (rather than purely ‘competitive’) markets. While in a competitive market the focus is for competition to deliver consumer benefits, in a well-functioning retail energy market, competition is combined with other tools – such as effective regulation – in order to deliver the desired consumer outcomes (for example consumer involvement and security of energy supply).” (p 9) *Ibid*.

that a competitive market would deliver. In UK competition policy terminology, the well-functioning market as promoted by CEER is intended to identify and address issues associated *both* with competition *and* with the public interest.

71. In contrast, as explained earlier, under the Enterprise Act 2002 the CMA's statutory duties in regard to market investigations relate explicitly to competition issues, and not to the public interest insofar as that differs from competition. Thus, for the CMA *Energy* inquiry group to define (however obliquely) the well-functioning market in terms of desired outcomes – in the tradition of Ofgem and CEER – seems to give the CMA the statutory ability and responsibility to take steps to secure these desired outcomes. But it also raises the question whether this is exceeding the CMA's statutory remit in order to pursue goals related to the group's perception of the public interest.
72. Before reaching judgement on the impact of Ofgem's prior involvement and the consistency of the approach with the Enterprise Act 2002, we must consider that other factors may have influenced both Ofgem and the CMA. Part Two of this paper now examines two such factors, which turn out to be intertwined: the evolving policies of successive Governments and the impact of behavioural economics.

## **PART TWO: THE ROLE OF GOVERNMENT AND BEHAVIOURAL ECONOMICS**

### **14. Conservative Government policies (May 1979 - April 1997)**

73. Conservative Governments in power from May 1979 to April 1997 introduced the Gas Act 1986 and Electricity Act 1989 which privatised the gas and electricity industries and created the corresponding regulators Ofgas and Offer. Like other utility sector regulators, these were independent bodies, responsible to Parliament but not to ministers or the Government of the day. The Acts gave regulators and ministers relatively simple statutory duties: in electricity, primarily to secure that reasonable demands for electricity were satisfied, to secure that licensees could finance their licensed activities, to promote competition and, subject to the above, to protect the interests of consumers and, after some other duties, to take into particular account the interests of rural, disabled and pensionable age consumers. Apart from transitional arrangements for coal and nuclear in the early years, and a limited subsidy for renewable energy in later years, these Conservative Governments explicitly rejected the concept of an energy policy.
74. In this period, promoting competition in the utility sectors primarily meant restructuring previously monopoly industries; identifying, removing and reducing statutory and other barriers to new entry; and in particular opening the retail energy markets to competition.
75. Competition policy was based on the Fair Trading Act 1973 which created the Director General of Fair Trading (DGFT) and continued the role of the Monopolies and Mergers Commission (MMC). The Competition Act 1980

made limited extensions to their roles. Intentions to make further reforms were discussed but not implemented.

## 15. Labour Government policies (April 1997 – September 2008)

76. Labour Governments from May 1997 to September 2008 were generally pro-market and pro-competition but also more explicitly pro-consumer and with strong views about fairness and the nature of the competitive market that they wanted. The March 1998 Green Paper wanted the “right balance of competition and regulation” to ensure “a fair deal for consumers”.<sup>55</sup> It said that “all consumers have benefited from liberalisation; but some have benefited more than others. We are concerned that in the energy sectors, disadvantaged customers may have benefited least.” It wanted “to ensure that, as competition develops, the gains do not go disproportionately to one group of consumers at the expense of others”. (para 1.23)
77. This policy implied, amongst other things, qualifying the duty to promote competition, strengthening the duty to protect consumers, giving the sector regulator additional duties, transferring powers from the regulator to government, and taking powers to guide the sector regulator in the discharge of its duties.
78. More specifically, the Utilities Act 2000 replaced individual regulators at Ofgas and Offer by the Gas and Electricity Market Authority (GEMA), the governing body of the Office of Gas and Electricity Markets (Ofgem). It modified the original regulatory duty to promote competition to read “to protect the interests of consumers ..., *wherever appropriate* by promoting effective competition” (italics added). It required GEMA/Ofgem to have regard to the interests of low income consumers, the chronically sick, the disabled, pensioners and consumers in rural areas. It specified that “consumers” should include both existing and future consumers. It required GEMA to publish a forward work programme before each year. It provided that “The Secretary of State shall from time to time issue guidance about the making by GEMA of a contribution towards the attainment of any social or environmental policies set out or referred to in the guidance.” It also gave the Secretary of State power to adjust energy charges to help disadvantaged groups of customers (which the Explanatory Notes to the Act described as a cross-subsidy). And it established a new independent Gas and Electricity Consumer Council (later known as Energywatch) with the job, inter alia, of advocating the interests of all consumers to the regulatory authorities, Government, utility companies and others.

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<sup>55</sup> *A Fair Deal for Consumers: Modernising the Framework for Utility Regulation*, Green Paper, March 1998. “1.15 Competition is a key means of ensuring value and choice for all consumers. But we must make sure that, for these essential services, the benefits of competition do not go disproportionately to the better off, and that poorer consumers are protected. There are particular concerns that this may not be happening in the rapidly developing energy sectors. We therefore want to work in partnership with the utility companies and the regulators to create the right balance of competition and regulation: one which ensures that services are available to all consumers – the rural and the poor as well as the urban and the affluent – on fair terms.”

79. In 2003 the DTI appointed Sir John Mogg as new chairman of GEMA. Ofgem appointed Alistair Buchanan as Chief Executive. Looking forward, on 1 January 2008 Ofgem appointed Andrew Wright, as Managing Director, Markets. They were, respectively, an EU civil servant, a financial sector analyst and an equities research analyst, whereas the previous heads of Ofgas, Offer and Ofgem had all been trained economists.<sup>56</sup>
80. Meanwhile, the Competition Act 1998, which harmonised UK competition policy with EU competition policy, also replaced the MMC by the CC. In 1999 the Department of Trade and Industry (DTI) promoted the concept of “confident consumers, making informed decisions”, aiming to create “demanding customers” and promising to provide access to the necessary information, while at the same time focusing “on the needs of those with less developed consumer skills”.<sup>57</sup>
81. As explained in Part One of this paper, the Enterprise Act 2002 enabled the CC to carry out market investigations, and required the CC to have regard to competition criteria and not to public interest criteria. It also gave the CC greater powers and independence than the MMC had had – for example, to make decisions on enquiries rather than to make recommendations to Government, and to take appropriate actions and measures (remedies) following findings of adverse effects on competition. It set up the Competition Appeal Tribunal (CAT) to hear appeals against decisions of the OFT, sector regulators and the CC.
82. Importantly for present purposes, the Act made explicit that the features of a market that might have an adverse effect on competition included not only the structure of the market and the conduct of any supplier, but also any conduct of customers including any failure to act or any other unintentional conduct. From time to time the MMC had found that the conduct of customers had an adverse effect on competition, but the governing Acts had not previously identified customer conduct as a feature to look for. The 2003 *Guidelines* devoted two of their 50 pages to customer conduct, under the headings switching costs and information asymmetries.

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<sup>56</sup> In 2013, Lord Mogg referred to Buchanan’s “transformational role in leading Ofgem from a body that was essentially an economic regulator ten years ago to its current and far more multi-dimensional purpose and activities”. Chairman’s Foreword to Ofgem’s *Annual Report and Accounts* 2012-13, p 5.

<sup>57</sup> *Modern Markets, Confident Consumers*, White Paper, Cm 4410, DTI, 22 July 1999. “A fair deal and prosperity go hand in hand. Confident consumers, making informed decisions in modern, competitive markets, promote the development of innovative and good value products.” ... “the Government has set a new agenda: to promote open and competitive markets; to provide people with the skills, knowledge and information they need to become demanding consumers;” ... “The White Paper will benefit all consumers but the Government will focus in particular on the needs of those with less developed consumer skills, those who are socially excluded and those on low incomes who can least afford to make a bad purchase.” “Open and competitive markets are the best guarantee of a good deal for consumers. They encourage innovation and ensure competitive prices. The Government is putting in place a framework that fosters free and fair competition, but is tough on those who seek to damage the competitive process.” “To make informed choices, consumers need reliable information on price, quality and the safety of products. The Government will take steps to ensure that consumers have access to accurate, comprehensive and comprehensible information.” (Overview)

## 16. Ofgem's retail policy until 2008

83. In this context of a pro-competitive Government policy with a particular concern for disadvantaged customers, the new energy regulator Ofgem reported positively on the evolution of competition while at the same time addressing a variety of concerns in the residential market.
84. Thus, in 2000 Ofgem developed its Social Action Plan, and reported annually on it. In 2002 Ofgem abolished the price caps because it considered that competition was now effective<sup>58</sup> Competition could deliver more benefits for customers than regulation, and regulation could jeopardise competition, particularly regulation focused on prices to particular customer groups.<sup>59</sup> Ofgem proposed to focus instead on use of competition and consumer law powers.<sup>60</sup> A year later it outlined "Ofgem's substantial programme of work to remove continuing obstacles to competition (for example, reviewing the transfer process, tackling misselling, reforming rules for objecting to switches, improving competition for dynamically teleswitched customers, as well as enforcing competition law)".<sup>61</sup> It also sought to improve customer information and billing standards.<sup>62</sup>
85. In 2005 a 'super-complaint' from Energywatch argued that the billing processes of gas and electricity suppliers were significantly harming the interests of consumers. Ofgem concluded that, "for the vast majority of customers, the competitive energy market is working well... However, for the relatively few customers that have reason to complain, there is evidence that the market does not always serve them well".<sup>63</sup> It proposed an Ombudsman and a prohibition on back billing to deal with some legacy problems in a proportionate way.

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<sup>58</sup> Ofgem, *Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals*, February 2002. Ofgem's Chief Executive was quoted as saying "The evidence is overwhelming that competition is effective across all social groups and all methods of payment". BBC News 15 February 2002.

<sup>59</sup> "In early 2002 it was already clear that competition was bringing substantial benefits to customers, including vulnerable customer groups. These benefits already included substantial price competition, and it was evident that suppliers were investing and innovating as a result of competitive pressure. These are benefits Ofgem judges could not be achieved through direct regulatory intervention. Ofgem's analysis in early 2002 was that, on the one hand, competition would provide greater benefits, for all customer groups, than price regulation; and on the other, that on-going price controls posed serious risks of braking or throwing into reverse the development of competition. These risks were judged to be the more serious if regulation were to be more tightly focused on prices paid by particular customer groups." Ofgem, *Domestic gas and electricity supply competition*, 7 June 2003, para 3.6.

<sup>60</sup> Ofgem 2002, *op cit*, Executive summary.

<sup>61</sup> Ofgem, 2003 *op cit*, p ii.

<sup>62</sup> Standard licence conditions put various obligations on suppliers with respect to the provision of information and response to customer queries about charges. In 2004 Ofgem noted concerns about one third of customers finding it difficult to compare prices, high levels of customer dissatisfaction over the calculation of bills and frequency of meter reads, and the importance of the right feedback to encourage energy efficiency. Ofgem concluded that it was appropriate to encourage the industry to work with the new consumer body Energywatch to develop a billing standard to address these concerns. Ofgem, *Improving information for customers, An occasional paper*, July 2004.

<sup>63</sup> *Ofgem's response to the Super-complaint on billing processes made by the Gas and Electricity Consumer Council* ("Energywatch"), Decision document, Ofgem, July 2005, p 1



86. From 2002 to 2007, Ofgem issued a number of retail market reports that noted the continued development of competition. For example, in July 2007 Ofgem reported vigorous price competition for all customers; innovation by suppliers in terms of fixed and capped price deals, cheaper online deals and green tariffs; improving customer service; and customer switching rates at their highest in four years.<sup>64</sup> Ofgem claimed that the UK had the most competitive retail market in the world.

87. Thus on 16 January 2008, when Ofgem issued its press release headed “Market is sound – Ofgem assures Chancellor”, this was in accordance with its policy over the previous decade. Yet on 21 February 2008, Ofgem issued its next press release headed “Ofgem launches probe into energy supply markets”, which was “in response to public concern about whether the market is working effectively” and “to address mounting concern among customers that could undermine competition”. There was speculation as to whether Ofgem really believed there might be a problem with the market, or was just doing this to convince the public that the market was sound.

## **17. The political context of Ofgem’s change in retail policy**

88. Why did Ofgem change its mind? Although Ofgem was reporting vigorous competition in July 2007, pressure on it was building. From 2005 to 2007 domestic energy prices had increased by about 50%. Energywatch argued that energy markets were failing consumers, that “Ofgem has been complacent at best and negligent at worst”, and that the OFT or the CC should step in.<sup>65</sup> Modest tariff reductions in spring 2007 gave way to warnings of further increases of up to 40% in 2008.<sup>66</sup> Announcements of price increases began on 4 January 2008 and continued with some frequency throughout the year. There were newspaper allegations of “rip-off” and criticisms of Ofgem’s inaction. It was said that “The Chancellor calls crisis meeting with Ofgem over price rises”.<sup>67</sup> The meeting took place on 15 January.<sup>68</sup>

89. On 22 January Energywatch wrote to the Select Committee on Business and Enterprise to challenge Ofgem’s view that the market was sound.<sup>69</sup> On 31

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<sup>64</sup> Ofgem, *Domestic Retail Market Report – June 2007*, London, 4 July 2007.

<sup>65</sup> *How energy markets are failing consumers*, Energywatch, March 2007, pp 40-1. See also Energywatch Memorandum (22 March 2007) to House of Lords, *Regulators – First Report*, 23 October 2007.

<sup>66</sup> *Energy prices, fuel poverty and Ofgem*, Select Committee on Business and Enterprise, Eleventh Report of Session 2007-08, Volume I, Report, 16 July 2008, p 5. Also GEMA meeting notes, 13 December 2007, note 6.

<sup>67</sup> Headline in *Marketing Week*, 7 January 2008

<sup>68</sup> Ofgem “confirmed that Britain’s competitive market in energy is working. However, bills are being driven up by rising global energy costs (oil, coal and gas), the cost of curbing climate change, increased investment in the energy networks to ensure safe and reliable energy suppliers for customers and a lack of market liberalisation in the rest of Europe.” Ofgem sought to assist the Government by renewing its proposal that “a windfall worth £9 billion of tradeable permits ...could be used to help customers in fuel poverty”. Ofgem press release 16 January 2008.

<sup>69</sup> Energywatch expressed concern about many aspects of the energy sector, including energy price increases, increasing market concentration, vertical integration, foreclosure of new entry, the limitations of using the number of customers switching as a measure of competition, and the limitations

January, appearing before the Select Committee, the Energy Minister denied that the Chancellor was putting pressure on Ofgem, and said that competition was a matter for Ofgem. However, he expressed concern about mis-selling, the fact that many vulnerable customers were not readily able to take advantage of switching, and whether the charges for prepayment meters were unduly high. The reappointment a few days later of Ofgem chairman Sir John Mogg for a further five year term suggests that Ofgem still enjoyed Government support. Indeed, the Government regarded Ofgem's assistance as important for carrying out its wider energy policy.<sup>70</sup>

90. On 5 February the Committee announced an investigation into Energy Prices, Fuel Poverty and Ofgem. On 21 February Ofgem announced that it, too, would be launching an investigation into the retail energy markets.
91. At the Committee's first hearing on 20 May, the chairman remarked "we have never had such a large volume of submissions from the outside world". This eventually included six submissions from Energywatch, which was Ofgem's most powerful critic. Its Chief Executive Allan Asher, a very effective advocate, was the first witness to appear before the Committee. Other consumer groups and academic economists expressed their concern about aspects of the competitive market.
92. In subsequent written evidence the Department for Business, Enterprise and Regulatory Reform (BERR) welcomed Ofgem's Probe and stressed the importance of the benefits of competition being available to all customers.<sup>71</sup> It indicated an intention to update its statutory guidance to Ofgem in that respect.<sup>72</sup> Switching by the fuel poor was especially important.<sup>73</sup> BERR had asked Ofgem to ensure that prepayment meter customers were treated more

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of the Government's fuel poverty strategy. Energywatch reported the next day that fuel poverty was at its highest level since 1999. Energywatch, Letter submitted to Business and Enterprise Select Committee, *Energy prices, fuel poverty and Ofgem*, Ev 266-8

<sup>70</sup> "There are a number of important challenges facing energy policy in the next few years, such as the need to ensure security of supply, tackle fuel poverty and address sustainability. Ofgem is a crucial player in meeting our energy goals and I am confident that under Sir John's leadership, they will maximise their contribution to achieving these goals." Energy Minister Malcolm Wicks, BERR news release, 4 February 2008.

<sup>71</sup> "Ministers have recently met with Ofgem to discuss these issues, and will continue to do so. In particular we welcome Ofgem's concern with ensuring that the benefits of competition are available to all consumers." (para 10, Ev 145) "This detailed probe will investigate whether the market is working well for all customers, not just groups using particular payment methods. (para 51 Ev 149)

<sup>72</sup> There were no plans to amend or add to Ofgem's duties, but "we believe that it may be appropriate to update Ofgem's statutory social and environmental guidance. ... [A forthcoming consultation] will reflect our expectations for Ofgem's role in ensuring that the benefits of the competitive markets are available to low income and vulnerable consumers, in facilitating switching among those groups, and in meeting overall sustainability goals." (para 55 Ev 149) The Guidance was first issued in 2002 and revised in 2004 but then not again until 2010.

<sup>73</sup> "The Government has been working with Ofgem to enable the fuel poor to use the competitive energy market to their advantage by switching to suppliers offering the lowest tariffs. Ofgem is currently working with the Citizens Advice Bureaux to help vulnerable customers to switch to a better tariff and is conducting research into barriers that might prevent the fuel poor from switching supplier." (para 67, Ev 150)

fairly (ie that the tariff differential did not exceed the cost differential), and would take action itself if sufficient progress was not made.<sup>74</sup>

93. The Committee “shaped our inquiry to ensure that it can feed into Ofgem’s work”, noted that “We intend to look closely at Ofgem’s findings when they are available”, and issued its Report in July 2008.<sup>75</sup> It explained that “Concern about rising prices in the retail sector first prompted our inquiry.” (p 29) It endorsed the concerns about the market as expressed by Energywatch and others, and recommended that Ofgem take numerous actions with respect to improving customer switching and narrowing the gap between tariffs for different payment types. It also expressed concerns related to off-network gas consumers. Its recommended approach “will, however, need Ofgem to demonstrate a rather greater sense of urgency than has been made apparent so far”. (p 56)
94. The Government agreed with most of what the Committee recommended.<sup>76</sup> It had asked Ofgem to advise on the possibility of requiring companies to report separately on their profits in generation and supply. (p 10) It “shares the Committee’s interest in finding new ways of engaging customers”, and had consulted on revising the guidance to Ofgem with respect to switching. (p 13) It re-emphasised its concern and warning about charges for different payment types.<sup>77</sup>

## **18. Ofgem’s Probe Initial Findings (October 2008)**

95. In this highly charged political context, where there was broad agreement about many concerns, it would have been difficult for Ofgem to find that nothing was amiss and to take no further action. Working closely with Government, Ofgem issued its *Probe Initial Findings* on 6 October 2008. For the substance of these findings, the familiar and novel features, the (limited) economic analysis underlying the proposals, and the subsequent discussion of them, see Littlechild (August 2014). Very briefly
- the Probe did not find excess profits, because “assessment of suppliers’ profitability is difficult” (p 114); nor did it find competition less effective

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<sup>74</sup> “70. Households that use prepayment meters and typically pay around £55 more a year for their energy than customers paying by standard credit and £144 more than those who pay by direct debit. It is not clear that these differentials simply reflect the extra cost to companies of servicing prepayment meter customers, nor is it clear whether prepayment customers are being given enough information about other cheaper payment methods. We have therefore asked Ofgem and suppliers to develop proposals to ensure prepayment meter users are treated more fairly. If sufficient progress is not made by next winter the Secretary of State for Business Enterprise and Regulatory Reform is prepared to use his statutory powers to reduce the differential between prepayment meters and other forms of payment.” (para 70 Ev151)

<sup>75</sup> *Energy prices, fuel poverty and Ofgem*, Select Committee on Business and Enterprise, Eleventh Report of Session 2007-08, Volume I, Report, 16 July 2008, p 3

<sup>76</sup> *Energy prices, fuel poverty and Ofgem: Government Response to the Committee’s Eleventh Report of Session 2007-08*, Select Committee on Business and Enterprise, (dated 2 October) 7 October 2008

<sup>77</sup> “If Ofgem’s analysis does show that disadvantaged groups are facing unjustifiably high charges then we will in the first instance expect Ofgem and the energy suppliers to provide the solution. If sufficient progress is not made by this winter, the Secretary of State will consult on legislation, with a view to reducing any unjustified tariff differentials.” (p 13)

than before, in fact “the transition to effective competitive markets is well advanced and continuing” (p 1);

- however it found “some important areas where the transition to competitive markets now needs to be accelerated. Many consumers are not yet benefiting fully from the competitive market and vulnerable consumer groups are disproportionately affected.” (p 1); a particular concern was differential pricing: ‘in-area’ versus ‘out-of-area’ and between payment types (pp 8,9);
  - a package of 20 new measures, grouped into 5 actions, was proposed to address these issues; many of these findings, concerns and measures were not new (cf the Social Action Plan);
  - novel features or emphases included the use of customer segmentation, quantification of price differentials in relation to cost differentiation, the characterisation of existing price differentials as “unfair”, the emphasis on disengaged customers, the conclusion that “we cannot rely on switching by the active minority in energy supply to drive down prices for inactive consumers”, and the proposal to introduce non-discrimination conditions (para 8.39);
  - there was no discussion of the pros and cons of these proposals, remarkably since Ofgem had twice previously considered and rejected non-discrimination conditions because linking the higher prices paid by inactive ‘target’ customers to the lower prices paid by more active ‘marker’ customers could increase the latter prices;
  - closer examination revealed that Ofgem now envisaged such a redistribution of income: equalisation of prices had become an end in itself;
  - the assumption (by Ofgem and others) that price differentials not equal to cost differentials implied a lack of competition was not justified: it could be consistent with strong competition, so that preventing such differentials could prevent rather than achieve a more competitive market;
  - although Ofgem had shown that “the single largest factor affecting a supplier’s churn is its relative price”, (para 4.14), it gave no consideration to the potential adverse impact of its non-discrimination clause on the extent of customer switching;
  - leading regulatory economists challenged the proposed non-discrimination condition (see fn 3 above) and Professor Yarrow, the economist Non-Executive Director of GEMA, resigned over the issue in March 2009; Ofgem argued in response that “the net effect on welfare is ambiguous” (para 5.34) and “we have attached more weight to the benefits to vulnerable customers” (para 11.5);

96. Why did Ofgem adopt this and subsequent policies? Littlechild (August 2014) related its change of stance to pressure of the continuing increase in energy prices, the impact of successive Government policies and the absence of economists in the most senior posts at Ofgem. The previous section of this paper, with its more detailed documentation of the events leading up to Ofgem’s Probe and *Probe Initial Findings*, tends to confirm the importance of these factors.

97. It also provides further evidence about the origins of some of the Committee and Ofgem proposals and analyses. For example, although there were widespread allegations of market power, it was said that there was no real ability to calculate profit, let alone demonstrate excess profit in the retail

sector.<sup>78</sup> Allan Asher of Energywatch was asked whether companies setting similar prices might not indicate a highly competitive market rather than the lack of it. His response referred to “company profits and actual high levels of inefficiency – and it is not necessarily huge profit. Often they have just bloated cost structures and they are inefficient and, sadly, that is what we have ...”.<sup>79</sup> This remark by Asher may have been the origin of Ofgem’s suggestion in the October 2008 *Probe Initial Findings* (subsequently adopted by the CMA as documented above) that market power was reflected in inefficient costs and cost differences. When Ofgem appeared before the Committee a month after Asher, Andrew Wright, too, suggested that significant cost differentials between suppliers were an indication of lack of competition.<sup>80</sup>

98. In another exchange, Wright was asked about vulnerable people being conned by switching. He volunteered that “One feature one would also expect from a well-functioning market is that the benefit is not available just to those who switch.”<sup>81</sup> Not surprisingly, the Committee seized upon this.<sup>82</sup> Citing this view, it went on to recommend that Ofgem should “investigate how all customers could benefit from competition, whether they switch or not”.<sup>83</sup> Ofgem had made a rod for its own back. The non-discrimination condition presumably seemed the most convenient way to discharge the commitment it had made, and to respond to the pressures upon it.

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<sup>78</sup> This was a point made by Dieter Helm (Ev 394). The Select Committee said “While the ‘Big 6’ claim to be losing money in domestic supply, there is evidence that they are earning increased profits from their wholesale operations. ... we recommend that Ofgem conducts further work to understand where the profits are being made within the energy chain.” (Report para 56) However, Littlechild (August 2014), using Ofgem’s *Probe* publications, calculates that industry profit in the supply business was approximately zero at that time. This is consistent with later CMA evidence (fn 47 above).

<sup>79</sup> *Energy prices, fuel poverty and Ofgem*, Select Committee on Business and Enterprise, Eleventh Report of Session 2007-08, Volume II, Oral and written evidence, 16 July 2008, Mr Alan Asher 20 May 2008, Q190 Ev24.

<sup>80</sup> He observed that “there is quite significant variation between suppliers” with respect to the differential between the additional price and cost of supplying on a prepayment basis compared to direct debit. He commented that “one would expect in a competitive market for cost differences of that size to be competed away. We would be concerned if such cost differences were sustained and those increased costs were passed through to customers in a competitive environment”. *Ibid.* 17 June 2008, Q581, Ev 85

<sup>81</sup> His preceding comments were as follows. “Does consumer choice and switching provide adequate price discipline on suppliers? ... There are really two issues. One is to ensure that consumers have good information on which to make choices, the other is to ensure that the benefits of competition are available to all consumers, not just those who are engaging in the market.” (Q591, Ev 87)

<sup>82</sup> “81. Ofgem’s Chief Executive [it was actually the Managing Director, Markets] told us a ‘feature one would expect from a well-functioning competitive market is that the benefit [of lower prices] is not available just to those who switch’. If this were the case, one would expect to see the prices charged by incumbent suppliers to their home customers roughly matching the offers made by competitors. However, Figure 10 below shows that, over time, average incumbents’ prices have consistently remained above the best offer of their competitors. As National Energy Action put it: ‘In effect the incumbent supplier treats ‘legacy’ customers as a cash cow’.”

<sup>83</sup> “82. ... We believe its recommendations should include new ways to engage consumers that have not switched away from their incumbent supplier, and it should consider ways in which customers who do switch can make more informed choices. Ofgem should also investigate how all customers could benefit from competition, whether they switch or not, for example by preventing energy companies from over-charging their legacy customers.”

## 19. Labour Government policy (October 2008 – April 2010)

99. On 3 October 2008, a new Department of Energy and Climate Change (DECC) was created, headed by Ed Miliband as Secretary of State. He had a much more interventionist perspective than his predecessors: important decisions could not be left to the market.<sup>84</sup>
100. Ofgem issued its *Probe Initial Findings* on 6 October 2008. On 9 December 2008, making “his first major speech on UK energy policy”, Mr Miliband was very critical of the energy companies and gave strong support to Ofgem’s pro-active policy in the retail market.<sup>85</sup> Ofgem’s proposed package of measures including the non-discrimination condition was formally implemented in September 2009. In October the Government again gave strong support to Ofgem’s policy, and indicated that it would work with Ofgem.<sup>86</sup> It also foreshadowed clarification of the regulatory remit in respect of consumer protection.
101. In January 2009 the Energy Minister announced the appointments of four new Non-Executive Directors at GEMA. Until then, such directors had been entirely from the world of business and finance, plus one Professor of Economics. In contrast, of the three new appointments, two were from consumer bodies and a third was an environmental engineer/scientist.<sup>87</sup> Professor Yarrow was not replaced by another economist.<sup>88</sup> The consumer bodies with which the two new appointees were associated were critics of Ofgem’s pre-2008 policy and strong supporters of the Probe and its remedies (as indicated by their Probe consultation responses). This radical change to the

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<sup>84</sup> On 16 October, two weeks after taking office, he announced the intention to cut greenhouse emissions by 80% by 2050 rather than 60%. Within five months he had “overturned the old energy department stance” on coal-fired power stations, announced a “complete rewrite of UK energy policy”, and indicated that important decisions could not be left to the market. *The Guardian*, 24 April 2009

<sup>85</sup> “[T]he recent Ofgem report found that millions of vulnerable customers who were on pre-payment meters, off the gas grid, or served by companies that used to be the local monopoly were losing out. ... There can be no excuse for these practices, and unless all energy companies accept their responsibility for ending them, we will use our powers to do so. Ofgem set a deadline of December the first and will report shortly on what they propose. We are determined to work with them to root out unfair practices hitting the most vulnerable.” *The Rise and Fall and Rise Again of a Department of Energy*, A lecture by Ed Miliband, Energy Futures Lab Annual Lecture 2008, Imperial College London, 9 December 2008, p. 9.

<sup>86</sup> “The Government firmly believes that the regulator should be active in protecting consumers and their interests, whether through the promotion of effective competition or through other, more direct, interventions. We have welcomed the measures developed following Ofgem’s probe. ... the Government has recently stated its intention to clarify the remit of the regulator in relation to consumer protection at the earliest legislative opportunity”. (p 8) *Government Response to the Efra Select Committee Inquiry: Energy efficiency and fuel poverty*, Cm 7719, [8] October 2009.

<sup>87</sup> DECC press release 14 January 2009. David Harker was formerly Chief Executive of Citizens Advice and previously Managing Director at Sense, the national disability charity. John Howard was a broadcaster on Radio 4 “championing consumer issues for 14 years”, and a council member of Energywatch. Professor David Fisk was Professor of Engineering for Sustainable Development at Imperial College and previously Chief Scientist at DOE and other departments.

<sup>88</sup> This was not remedied for nearly three years. Eventually, the Coalition Government’s Review of Ofgem (see below) held that “the board [GEMA] would be strengthened further with the recruitment of a non-executive with specific economic regulation expertise”. Paul Grout, Professor Political Economy, was appointed in November 2012.

composition of GEMA reflected the then-Government's policy, and entrenched Ofgem's new direction.

102. Meanwhile the Energy Act 2008 (November) inter alia gave the Government power to specify feed-in tariffs and transferred metering responsibilities from Ofgem to the Secretary of State. The Government revised the Guidance to Ofgem, making particular reference to pricing by payment method and to vulnerable customers.<sup>89</sup>

103. On 19 November 2009 the Government introduced a Bill that became the Energy Act 2010 (April). The Act had three principal objectives, the third of which was “the strengthening of the powers of Government and the regulators to ensure that the energy markets are working fairly for consumers and delivering secure and sustainable energy supplies”.<sup>90</sup> Inter alia, the Act further specified what consumers' interests were.<sup>91</sup> The duty to promote competition was further demoted: government and the regulator should instead look first to more active regulation.<sup>92</sup> This was because competition could take longer and might not protect some groups of customers.<sup>93</sup> The Act also extended the Secretary of State's power (initially established in the Utilities Act 2000) to adjust tariffs in case of cross-subsidisation between fuels whereby some (disadvantaged) customers faced excessive prices not justified by cost differentials.

104. It previously seemed to me that “there is no evidence that Government initiated or determined Ofgem's policy as opposed to supporting it. Responsibility for the thrust and detail of the policy seems to rest with Ofgem.” (Littlechild August 2014) On closer examination, it now seems that, while the detail of the policy rests with Ofgem, the thrust of it very much

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<sup>89</sup> “21. Ofgem should: ... ensure that consumers, including those paying by a prepayment meter or by standard credit, do not suffer any undue economic disadvantage as a result of their payment method; make recommendations and take appropriate steps to help ensure that – low income and vulnerable customers are able to benefit from competition, and are not unfairly disadvantaged by suppliers' pricing strategies ...” *Social and Environmental Guidance to the Gas and Electricity Markets Authority*, DECC, [March] 2010

<sup>90</sup> Explanatory Notes to the Act. The first and second objectives were to introduce a framework to support carbon capture and storage projects, and “the introduction of schemes for the reduction of fuel poverty (which will introduce mandated social price support)”.

<sup>91</sup> The interests of electricity consumers “are their interests as a whole including their interests in the reduction of electricity-supply emissions of targeted greenhouse gases, and their interests in the security of supply of electricity to them”. Evidently these interests were not best served by leaving customers to decide for themselves in the market, or by leaving Ofgem to interpret them.

<sup>92</sup> The Secretary of State and Ofgem still had the duty to carry out their functions “wherever appropriate by promoting effective competition”, but this was now qualified: they were now required to consider “whether there is any other manner (whether or not it would promote competition) ... in which [they] could carry out those functions which would better protect those interests”.

<sup>93</sup> According to the Explanatory Notes accompanying the Bill, “78. Competitive solutions may take time to deliver, and the market may create barriers for some groups of consumers so that the promotion of competition may not be the most effective means of protecting their interests. These provisions clarify that Ofgem should consider using alternative types of solution to address the consumer detriment instead of, or alongside, measures to promote competition. Such solutions could include strengthened licence conditions and enforcement action, or other means that would prevent certain types of market behaviours.”

reflected what Energywatch, other consumer bodies and not least Government and the Select Committee were advocating.

105. The critical measure was the non-discrimination condition, with respect to prices in-area versus out-of-area. Independent economists argued that it would reduce competition and harm customers. (fn 3 above) Ofgem disagreed and sought to redistribute income (including to vulnerable customers, though it accepted that some such customers would be worse off). In effect, Ofgem no longer saw itself as an “economic regulator”, and turned a blind eye to economic analysis. The consequence was a reduction in retail competition, and a further blurring of the line between the nature of competition and the public interest, a blurring that would continue for the next six years and surface again in the CMA market investigation.

## **20. The rise of behavioural economics in competition and regulatory authorities**

106. While Ofgem’s *Probe Initial Findings* were at best sketchy on conventional economic analysis, they majored on what would later become familiar as behavioural economics. For example, there was a quite novel set of customer classifications.<sup>94</sup> And the first two proposed remedial Actions were described as Promoting more active customer involvement and Helping consumers make well-informed choices. A couple of years later it was acknowledged that “Ofgem has implicitly drawn on behavioural economics in our previous analysis of the retail market, including in the 2008 Energy Supply Probe”.<sup>95</sup>

107. The research of Kahneman and Tversky on behavioural economics began in the 1970s.<sup>96</sup> It took time to attract wider academic and professional interest. Kahneman received the Nobel Prize in Economics in 2002. Until the mid-2000s there seems to have been little or no explicit recognition of it by UK competition and regulatory authorities. Thus, the FSA’s 2006 *Guide to Market Failure Analysis* contained a balanced discussion of market failure and regulatory failure.<sup>97</sup> But it did not mention behavioural economics.

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<sup>94</sup> Customers were now classified as confident deal seekers 16%, unhappy potential switchers 17%, under-confident and nervous 13%, loyalists 25%, disengaged 7% and older 23%. Customer segmentation analysis carried out by FDS International, *Probe Initial Findings* Table 5.1.

<sup>95</sup> *What can behavioural economics say about GB energy consumers?*, Ofgem 21 March 2011, p 2.

<sup>96</sup> Tversky A and Kahneman D, “Judgement under Uncertainty: Heuristics and Biases”, *Science*, 185 (1974), 1124-1131. Kahneman D and Tversky, A, “Prospect theory: An analysis of decisions under risk”, *Econometrica* 47(2), March 1979, 263-292.

<sup>97</sup> “...all markets are imperfect to some degree. The mere presence of imperfections does not justify intervention. ... It really is important to be sceptical about the case for intervention in markets. Governments and regulators are also prone to failures and markets can work even when the odds seem massively stacked against them.” *A Guide to Market Failure Analysis and High Level Cost Benefit Analysis*, FSA, November 2006, p 1. It then cites the Director Callum McCarthy as writing “It is an argument too often deployed by those who favour intervention that any market failure justifies intervention. The strong – and to me correct – test goes beyond that: there must be both market failure and the prospect that intervention will provide a net benefit. This involves recognising that regulatory intervention has a cost and...a probability of failure.” (p 5) There is significant discussion (e.g. para 11) of regulatory failure.



108. In 2007 the FSA commissioned an experiment on the influence of insurance sellers on buyers, and the impact of information disclosure.<sup>98</sup> In July 2008 it commissioned a review of the behavioural economics literature with respect to choosing financial products.<sup>99</sup> In December 2008 it devoted a chapter of its discussion paper on consumer responsibility to behavioural economics.<sup>100</sup> This time, the possibility of regulatory failure was not mentioned.
109. In its 2008 Probe, Ofgem was arguably the first UK regulator to make substantial use of behavioural economics. It did not use that term at the time, as explained above.
110. In 2009 the OFT commissioned research on the psychology of scams.<sup>101</sup> The OFT and CC produced a report on road testing of consumer remedies.<sup>102</sup> The publication of *Nudge* popularised the concepts and possibilities of behavioural economics.<sup>103</sup> The Civil Service was interested at the highest level, and enlisted the help of “behaviour change experts”.<sup>104</sup> The Foreword to the subsequent report began “Influencing people’s behaviour is nothing new to Government ...”<sup>105</sup> Ofcom commissioned a report on experiments, and explained in March 2010 that “Ofcom has recently been

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<sup>98</sup> Information versus persuasion: experimental evidence on salesmanship, mandatory disclosure and the purchase of income and loan payment protection insurance, De Meza D, Irlenbush B and Reyniers D, FSA, 2007

<sup>99</sup> *Financial capability: a behavioural economics perspective*: A review of behavioural economics literature prepared for the FSA by David de Mesa, Berndt Irlenbusch and Diane Reyniers, Consumer Research 69, FSA, July 2008

<sup>100</sup> For example, “4.1 The general level of financial capability in the UK is low and consumers often fail to act in a completely rational manner with regard to their financial affairs. ...4.3 FSA, the Government and many firms make significant efforts to improve consumer capability ... 4.4 Psychology and behavioural economics can help us to focus these efforts by identifying a range of cognitive biases that consumers must overcome in order to act in their own best interests and how this might best be achieved”, *Consumer responsibility*, FSA Discussion Paper, DP08/05, December 2008 p.

<sup>101</sup> *The psychology of scams: Provoking and committing errors of judgment*, Prepared for the OFT by the University of Exeter School of Psychology, OFT1070, May 2009

<sup>102</sup> *Road Testing of Consumer Remedies*, OFT, CC and the Association of Competition Economics by London Economics, slide presentation London 9 July 2009. Co-authors Dr Paula Ramada (London Economics), Professor Stephen Huck (UCL – experiments), Stephen Link (FDS International – qualitative methods)

<sup>103</sup> Richard H Thaler and Cass R Sunstein, *Nudge: Improving decisions about health, wealth and happiness*, Yale University Press, New Haven, CT, 2008.

<sup>104</sup> “In 2009, Sir Gus O’Donnell, Cabinet Secretary and Head of the Home Civil Service, asked Matt Tee, Permanent Secretary for Government Communication, to review the implications of behavioural theory for policy-making. ... The programme began with a behaviour change summit in May 2009 ... The report is grounded in a series of interviews with senior civil servants, academics and behaviour change experts.”

<sup>105</sup> “Influencing people’s behaviour is nothing new to Government, which has often used tools such as legislation, regulation or taxation to achieve desired policy outcomes. But many of the biggest policy challenges we are now facing – such as the increase in people with chronic health conditions - will only be resolved if we are successful in persuading people to change their behaviour, their lifestyles or their existing habits. Fortunately, over the last decade, our understanding of influences on behaviour has increased significantly and this points the way to new approaches and new solutions.” (Foreword by Sir Gus O’Donnell & Sir Michael Bichard, *Mindspace: Influencing behaviour through public policy*, Institute for Government and Cabinet Office, 2 March 2010

doing some work on behavioural economics and its implications for regulation.<sup>106</sup>

111. In March 2010 the OFT produced an extensive and influential review of behavioural economics and its implication for competition and competition policy.<sup>107</sup> It introduced the frequently cited Access – Assess – Act framework for customer decision-making.<sup>108</sup> It noted that real economic actors are subject to ‘behavioural biases’ that often preclude this ideal sequence. “Arguably, behavioural biases simply take a place alongside other well-known market failures, such market power, asymmetric information, and externalities...” (p 7)
112. The OFT’s presentation was balanced, indeed cautious, insofar as it emphasised that behavioural economics does not necessarily imply more intervention.<sup>109</sup> “Markets can be self-correcting and interventions can potentially do more harm than good”. (p 30) And regulators too are subject to behavioural biases.<sup>110</sup>
113. However, the key message as received seemed to be that “While active and rational consumers and vigorous competition work together in tandem to deliver consumer benefits, the failure of either side of the circle can harm the effectiveness of markets.” (p 9) Regulators and competition authorities were used to tackling market failures, and here was another one. They now needed to transform real customers into active and rational consumers in order to enable competition to deliver its full consumer benefits.
114. Thus, by the time of the election in May 2010, the thinking was ripe for an explicit and significant application of behavioural economics in both regulation and competition policy. The new Coalition Government was keen to make such an application.

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<sup>106</sup> *Using experiments in consumer research*, Ofcom research document, 1 March 2010, p 1, covering *Experimental Economic Research*, Final Report, Ofcom, prepared by Charlotte Duke, Steffen Huck and Brian Wallace, October 2009

<sup>107</sup> *What does behavioural economics mean for competition policy?* OFT 1224, March 2010. A slightly later literature survey is cited in the CMA 2013 *Guidelines*. S Huck, J Zhou and C Duke, *Consumer behavioural biases in competition – a survey*, OFT 1324, Office of Fair Trading 2011.

<sup>108</sup> “In order for consumers to drive competition in the way described above, they ideally need to • **access** information about the various offers available in the market • **assess** these offers in a well-reasoned way, and • **act** on this information and analysis by purchasing the good or service that offers the best value to the customer. When any of these three elements of the consumer decision-making process breaks down, consumers' ability to drive effective competition can be harmed.” (pp 10-11)

<sup>109</sup> “Finally, even to the extent that there are persistent problems in markets, behavioural economics also emphasizes the difficulties that competition (or consumer) authorities can face in trying to correct for such biases. For example, behavioural economics tells us that simply providing more information may not be a good solution when consumers have problems assessing such information. As such, it is far from clear that a greater emphasis on behavioural economics implies more intervention. It may well imply less.” (pp 7,8)

<sup>110</sup> “...although this paper only discusses consumer and firm behavioural biases, this does not preclude the possibility of authorities having behavioural biases as well! This, and the previous two points, all caution us against being too paternalistic even when behavioural biases point to problems within the market.” (pp 34-5)

## 21. Coalition Government policy on retail energy regulation

115. The Coalition Government was in office from 11 May 2010 to 8 May 2015. Throughout the period, the Secretaries of State for Business, Innovation and Skills (at BIS) (Vince Cable) and for Energy and Climate Change (at DECC) (Chris Huhne then Ed Davey, formerly a Minister at BIS) were Liberal Democrats. The following sections set out in turn the policies developed by DECC and BIS over the course of the Coalition Government.

116. In July 2010 BIS explained that more efficient markets were a key to faster growth. This required “confident consumers, who are adept at exercising choice”.<sup>111</sup> The Government was also “reviewing the competition and sector regulation regimes to streamline them”. In the energy sector, costs were likely to rise considerably. Strong regulation was necessary to protect customers, particularly vulnerable ones.<sup>112</sup>

117. One of the Coalition Programme commitments was to review Ofgem, “to ensure that the regulatory framework ... would continue to deliver against our strategic objectives”.<sup>113</sup> In April 2011 BIS set out *Principles for Economic Regulation* which specified that economic regulators should focus on “ensuring the operation of well-functioning and contestable markets where appropriate” (p 4). The *Principles* also stated the Government’s legitimate role in “defining a strategic vision” and “a policy context for regulatory decisions”.<sup>114</sup> The *Principles* then provided the framework for assessing the options considered as part of the Ofgem Review.<sup>115</sup>

118. In July 2011 the Review concluded that a new Strategy and Policy Statement was needed, for Government to set strategic direction.<sup>116</sup> Previous

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<sup>111</sup> “Fair markets and empowered consumers are vital for a well functioning economy. Businesses need to know that they will be able to sell their products within a stable market to consumers. The consumers in turn need confidence that firms will not exploit them and knowledge to make informed choices. A lack of trust within markets can be a major cause of missed economic opportunity.” BIS, *A strategy for sustainable growth*, 17 July 2010, p 5. “Consumer confidence in markets is also essential to their proper functioning.” (p 11) “Confident consumers, who are adept at exercising choice, can therefore exert significant pressure on business practices without the need for burdensome regulation. There is growing evidence to show that empowered consumers act as a spur to drive competition and as a driver for firm-level innovation.” (p 12). BIS, *A strategy for economic growth – Economic annex*, 17 July 2010

<sup>112</sup> DECC had announced that “The UK needs to radically increase its use of renewable energy.” Its Energy Market Reform policy was “the single biggest change to this country’s electricity market in a generation”. *National Renewable Energy Action Plan*, DECC, 1 July 2010. “The unit cost of energy is likely to rise considerably in the future, and it is therefore important that energy companies do not inflate bills unnecessarily. All consumers and especially the most vulnerable must be respected and treated fairly. To deal with this, the Government is committed to strong regulation and zero tolerance of market abuse and poor customer service.” DECC, *Annual Energy Statement*, 27 July 2010, p 5.

<sup>113</sup> *Ofgem Review, Final Report*, July 2011, Ministerial Foreword.

<sup>114</sup> “27. Government has a legitimate role to play, defining a strategic vision of the likely needs and priorities over the long term and providing a policy context for regulatory decisions in the medium and short term.” BIS, *Principles for Economic Regulation*, 12 April 2011.

<sup>115</sup> *Ofgem Review, Final Report*, p 18

<sup>116</sup> “There is a need for an enduring solution that sees Government clearly taking responsibility for setting and communicating strategic direction, Ofgem’s independent regulatory decisions forming a

arrangements had proved inadequate.<sup>117</sup> The new Statement would “define policy outcomes that Government considers Ofgem to have a particularly important role in delivering”. (p 6) The Review sought to deliver “confidence that the regulator’s decisions would be aligned with the Government’s strategic policy framework”. (p 17) Ofgem would be required to report on progress in delivering these outcomes. And “it will be paramount to keep customers engaged in the market. The regulator’s role ... will be central to this.” (para 43)

119. Meanwhile, in November 2010 Ofgem (itself in process of being reviewed) noted a 38% increase in net retail profit margins and announced its intention to review the retail energy market again.<sup>118</sup> This was its Retail Market Review (known as RMR). Ofgem’s *RMR Findings and initial proposals* issued in March 2011 found a mixed picture, including the removal of some large unjustified price differences, no change across much of the market, and a deterioration in terms of complex pricing structures and increase in number of tariffs that were contributing to lower customer engagement. Ofgem proposed “to address confusion in the domestic market” by restricting the number of tariffs for standard evergreen products to one per supplier per payment method, and specifying a standard monthly charge, so that customers would have only one number to compare among suppliers, namely the unit rate. This unit rate comparison was, incidentally, a policy that Ofgem had considered and rejected just two years earlier.<sup>119</sup> I have elsewhere termed this Ofgem’s Procrustean Bed policy.<sup>120</sup>

120. In parallel with its *RMR Findings and initial proposals*, Ofgem issued a paper on what behavioural economics could say about energy consumers.<sup>121</sup> It explained how Ofgem had been using this approach in its Probe and now its RMR policy.<sup>122</sup> A table in the paper summarised how biases affected energy consumer decision-making, using the OFT’s Access-Assess-Act framework.

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logical and coherent part of this broader strategic policy framework, and ad hoc interventions avoided where possible.” (para 6)

<sup>117</sup> “Previous attempts to improve the alignment of the regulatory framework with Government strategy have included amendments to the duties ... and the introduction of the Social and Environmental Guidance ... However, these have not succeeded in consistently and transparently achieving the desired coherence between the overarching strategy and the regulatory regime. This disconnect can be attributed to ... the broad scope of the duties and the weak legal status of the Guidance.” (p 24)

<sup>118</sup> Ofgem press release 20 November 2010

<sup>119</sup> Ofgem, *Energy Supply Probe - proposed retail market remedies*, Ref 41/09 15 April 2009, paras 3.14 – 3.44, pp 15-17

<sup>120</sup> Stephen Littlechild, *Ofgem’s Procrustean Bed: a response to Ofgem’s Consultation on its Retail Market Domestic Proposals*, 23 January 2012. This can be found on Ofgem’s website as Response 1, RMR domestic informal responses, but the names of domestic respondents have been blacked out. A summary and slight extension of my response is in *Oxera Agenda*, February 2012, pp 1-5. Littlechild (August 2014) includes a critique of the Procrustean Bed and subsequent Ofgem policies.

<sup>121</sup> *Retail Market Review – Findings and initial proposals*, Ref 34/11, Ofgem, 21 March 2011. *What can behavioural economics say about GB energy consumers?* Ofgem, 21 March 2011. The BIS paper on using behavioural economics to empower consumers (see below) was published three weeks later.

<sup>122</sup> “Ofgem has implicitly used insights from behavioural economics for many years to help consumers by improving the functioning of the GB energy retail markets. In this discussion paper, we make these insights explicit. We draw together evidence from a wide range of sources to examine the over-arching themes from behavioural economics that are relevant to the GB energy retail markets and the Retail Market Review.” *Ibid.* (Overview)

121. Ofgem's proposals were discussed in advance with the Secretary of State, who issued a statement of support.<sup>123</sup> Likewise he supported Ofgem's further statement on 22 June 2011, as did consumer bodies and smaller market participants.<sup>124</sup> In September 2011 the Secretary of State proposed half a dozen new measures to protect customers.<sup>125</sup> He also indicated that the Government was negotiating directly with energy suppliers (apparently independently of Ofgem) for them to inform customers of their best tariffs.<sup>126</sup> This arrangement was firmed up in April 2012.<sup>127</sup> During Question Time in Parliament on 17 October 2012, the Prime Minister went further, when he suddenly announced (reportedly to the surprise of DECC and Ofgem) that energy suppliers would be required to put customers on the lowest tariff, apparently meaning the lowest tariff in the market.<sup>128</sup>
122. On 26 October 2012 Ofgem changed tack, having "listened to concerns" and recognised some "practical difficulties", though it did not explain what these concerns and difficulties were.<sup>129</sup> It abandoned its proposal to set uniform standing charges (the Procrustean Bed). It kept other requirements (including a price comparison guide and tariff information label) that it had proposed in December 2011, plus other requirements building on the Probe remedies. Most importantly, perhaps, it introduced additional restrictions to simplify the energy market. It now proposed that each supplier should be limited to a maximum of 4 tariffs per fuel per payment method, and tariffs should be simplified in other ways.<sup>130</sup>

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<sup>123</sup> At the GEMA special session on 28 February 2011 to discuss RMR issues, "the Chairman provided feedback from his recent meeting, together with the Chief Executive, with the Secretary of State DECC." Notes of a Special Session of the Gas and Electricity Markets Authority, 28 February 2011. *Ofgem energy market proposals: statement by The Rt Hon Chris Huhne MP*, DECC, 21 March 2011.

<sup>124</sup> "Ofgem today signalled its determination to press ahead with a radical overhaul of the retail energy market following wide support from consumers, Consumer Focus, Which?, CAB, Age UK and uSwitch along with independent generators and small energy suppliers." Ofgem Press Release R/16, 22 June 2011.

<sup>125</sup> The proposals included preventing companies from blocking action by the regulator, requiring companies to provide consumer redress, calling on Ofgem "to assess whether competition was being hindered by some energy companies that have high energy prices for millions of their consumers and yet offer much cheaper online deals that make it difficult for small suppliers to compete", speedier switching and customer guidance, and exploring the potential for collective purchasing and switching. *Huhne: More teeth for Ofgem, more rights for energy consumers*, DECC announcement, 20 September 2011.

<sup>126</sup> "The Government and energy suppliers have agreed in principle to ensure consumers know if their supplier has cheaper tariffs. Suppliers have agreed in principle to signpost consumers to cheaper deals information this winter, and we intend that by next year more bespoke information will be displayed on the bill itself." *Huhne, More teeth, Ibid.*

<sup>127</sup> "In April 2012, the Government reached a further voluntary agreement with the six largest energy suppliers for them to provide an annual communication to all customers helping them to identify what the best tariff options are for them and how to get them." Consumer Tariffs Amendments (powers a-e), *Impact Assessment IA No: DECC0126*, 8 May 2013, para 6.

<sup>128</sup> "David Cameron stands by 'lowest' energy tariff vow", BBC News, 18 October 2012.

<sup>129</sup> Ofgem, *The Retail Market Review – Updated domestic proposals*, Consultation, Ref 135/12, 26 October 2012, p. 9.

<sup>130</sup> The two fuels were natural gas and electric power. The three payment methods were direct debit to a bank account, cash or cheque on receipt of bill, and prepayment via a top-up card. Tariff simplifications included prohibiting most kinds of discounts, tariffs with multi-part rates and tariffs that had a fixed rate per month regardless of usage.

123. Ofgem’s revised proposals were also expanded to incorporate a version of the Prime Minister’s own proposal. The Secretary of State supported the proposals strongly: “these are the sort of measures I have been urging for some time”.<sup>131</sup> The Prime Minister’s office said that the Government “had been working with them [Ofgem] for some time”.<sup>132</sup> The Government announced that it would take power in the Energy Bill to require suppliers to do precisely the things that Ofgem now proposed to implement via licence amendment.<sup>133</sup> Section 139 of the Energy Act 2013 conferred the power to do this.
124. In July 2013 Ofgem wrote to the Secretary of State “to underline the extensive contribution Ofgem makes to the Government’s policy and the close collaboration and shared objectives the two have”.<sup>134</sup> Sections 131-8 of the Energy Act 2013 provided for the Strategy and Policy Statement proposed earlier. The draft Statement noted the importance of “close and cooperative relationships” between Ofgem and the CMA, and required that Ofgem “carry out its regulatory functions in the manner best calculated to further the delivery of the following policy outcomes”, which included a competitive market in which “consumers can easily identify the best deals available to them”, “there are high standards of customer service” and “costs do not fall disproportionately on low income and vulnerable households”.<sup>135</sup>
125. Energy prices continued to be a political problem. On 20 December 2012 the Energy and Climate Change Committee launched an enquiry into Energy Prices, Profits and Poverty. This and Ofgem’s various proposals to deal with the retail energy market stimulated a flow of counterproposals.<sup>136</sup> In December 2013, the Government announced a range of measures to reduce household energy bills by an average £50 a year.<sup>137</sup> This was not the end. In February 2014 it was said that the Prime Minister’s office was considering a state-run price comparison website.<sup>138</sup>

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<sup>131</sup> Secretary of State’s response to Ofgem’s Retail Market Review, 19 October 2012.

<sup>132</sup> Number 10 Press Briefing, 19 October 2012 Morning.

<sup>133</sup> The Government explained that its policy objective was to encourage retail competition through greater engagement of customers, its urgent aim was to keep energy prices down, time was of the essence and this power would speed up the process. *Impact assessment*, paras 46, 47. The *Impact Assessment* reproduces Ofgem’s arguments more or less verbatim. There are also references to “uncertainty in the retail market due partly to the length of time Ofgem has been considering reform”, and “uncertainty ... created by a long RMR process” (paras 57, 62).

<sup>134</sup> Social and environmental guidance to the Gas and Electricity Markets Authority, Ofgem letter to Secretary of State, 18 July 2013. Also subsequent letter 16 September 2014.

<sup>135</sup> *Strategy and policy statement, A consultation on the draft statement*, DECC, URN 14D/271, 14 August 2014, p 20. DECC published a *Summary of responses* on 27 March 2015 but did not issue a final Statement.

<sup>136</sup> In December 2012 Which? proposed a single price per unit with no standing charge. In September 2013 Ed Miliband promised an energy price freeze if Labour were elected in 2015. In October 2013 John Major proposed a windfall tax on energy companies. In July 2014 SSE suggested each supplier should have a uniform national price, with cross-subsidies to even out regional distribution costs.

<sup>137</sup> The measures include reducing or deferring the environmental obligations on suppliers, getting distribution companies to defer increases in their network charges, and meeting some costs out of taxation rather than out of energy prices. *Government action to help hardworking people with energy bills*, DECC Press release, 2 December 2013.

<sup>138</sup> *The Times*, 1 February 2014.

## 22. Coalition Government and BIS on competition policy

126. Soon after it took office, the Coalition Government had set up the Behavioural Insights Team (called the Nudge Unit) within the Cabinet Office. In April 2011 BIS and the Team explained “how insights from the behavioural sciences can be used to help empower consumers, enabling them to make better choices and get better deals”.<sup>139</sup> Minister Edward Davey explained that “we want to see confident, empowered consumers able to choose the best deals,...”. (p 2) The Government’s *Plan for Growth* recognised that “markets rely heavily on active and informed consumers to drive competition”. (p 4) There was a page of “Lessons from Economics and behavioural sciences”. (p 12) There would be a new role for business and government: “in essence accelerating the shift towards more informed consumers and responsive markets”. (p 13)
127. There would also be “a shift in style of regulation and consumer protection” whereby “... the aim is to empower consumers so that their actions can shape markets...”. Consequently, “The Government wishes to see sectoral and industry regulators and self-regulatory bodies build on the approaches set out in this strategy.” (p 46) “A key objective will be to ensure that the main players in the new landscape continue the trend towards more proactive and consumer-focused interventions, including coordinating with each other to ensure that the types of approach set out in this strategy are taken forward”. (p 47)
128. The Conclusion was headed “Consumer empowerment as a driver of growth and fairness”. (p 48) Next steps included “Working with energy suppliers to provide, by the end of the summer, clearer information about the lowest available energy tariff.” (p 6)
129. In March 2011 BIS consulted on options for reform of the competition regime.<sup>140</sup> The Government’s “overarching objective” was “to maximise the ability of the competition authorities to secure vibrant, competitive markets, in the interests of consumers ...”. (p 2) It wanted changes “to support the competition authorities in taking forward high impact cases”. (p 2) Its proposal was to merge the OFT and the CC “to create a single Competition and Markets Authority which can play a leading role in achieving the over-arching objectives and delivering the desired outcomes”. (p 2) It also sought “ways to strengthen the operation of concurrent competition powers including joint working between the CMA and sector regulators”. (p 6) It was particularly concerned to increase the number of market investigation references by sector regulators. (paras 7.8 – 7.12)

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<sup>139</sup> *Better Choices: Better Deals, Consumers Powering Growth*, BIS & Cabinet Office Behavioural Insights Team, 13 April 2011. “Our vision is of consumers who know their rights and demand them, drive the development of new products and services and can work together to get the best deals.” (p 10) In October 2011 Daniel Kahneman’s *Thinking, Fast and Slow* (Farrar, Straus and Giroux) was published and proved a best-seller.

<sup>140</sup> BIS, *A competition regime for growth: a consultation on options for reform*, 15 March 2011

130. In March 2012, BIS confirmed that “the Government will ask the CMA and sector regulators to work together more closely. One way it will do this is through the proposed ‘strategic steer’ for the CMA. Greater sharing of expertise or secondments will improve case management...”<sup>141</sup>

131. Presumably BIS indicated to the CC the proposed nature of this new ‘strategic steer’. The revised *Guidelines* went far beyond the CC’s original intention “to capture the lessons the CC had absorbed since the introduction of the regime.”<sup>142</sup> Certainly the extensive discussion of weak customer response in the revised *Guidelines* responded to the behavioural economics literature, and to BIS’s April 2011 paper on empowering customers, and was well in tune with the subsequently published Steer.<sup>143</sup> Presumably the OFT, too, was involved in the revision as a potential joint component of the CMA. The new section in the *Guidelines* on the impacts and assessment of weak customer response began with an almost literal rendition of the OFT’s 2010 Access-Assess-Act formula.

“296. To drive effective competition customers need to be both willing and able to: access information about the various offers available in the market; assess these offers to identify the good or service that provides the best value for them; and act on this assessment by switching to purchasing the good or service from their preferred supplier.”

132. The Enterprise and Regulatory Reform Act (enacted April 2013) created the CMA. In July 2013 “the Government would like the CMA’s work to support its approach to growth, and ... considers that improved competition in particular sectors e.g. financial services and infrastructure (such as energy) is important to this”.<sup>144</sup>

133. The Government’s Steer was published when the CMA was established on 1 October 2013.<sup>145</sup> It “includes statements on how the work of the CMA should support the Government’s overarching priorities”. (p 6) “The CMA will be expected to have regard to the Steer, but retains full independence in how it approaches its work”. (p 10) Some respondents to the previous consultation, like the Bar Council, expressed “concerns about the ability of the CMA to be independent of Government when it has to have regard to Government-listed principles”.<sup>146</sup> The CMA chairman said that a competition authority should be “sensitive to both political currents and

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<sup>141</sup> BIS, *Growth, competition and the competition regime, Government response to consultation*, 14 March 2012, p 11.

<sup>142</sup> *Review of CC market investigation guidelines*, Letter to stakeholders 16 March 2010, p 1

<sup>143</sup> The CC’s initial April 2011 redraft of the 2003 *Guidelines* had one paragraph (38) noting three previous market investigations that had found the behaviour of customers to be a conduct feature that could limit competition (viz, insensitivity to price and interest rates and failure to explore alternatives). It used the phrase ‘weak customer response’ a couple of times, and made no mention of behavioural economics. In contrast, the June 2012 revision and the April 2013 final version extended the discussion of weak customer response to over twenty paragraphs, and each mentioned behavioural economics/bias/remedies/measures some 50 times.

<sup>144</sup> BIS, *Competition regime: Consultation on CMA priorities and draft secondary legislation*, 15 July 2013, para 2.6

<sup>145</sup> BIS, *Competition regime, Response to consultation on statement of strategic priorities for the CMA*, 1 October 2013

<sup>146</sup> Bar Council, *Response to the July 2013 BIS Consultation*, August 2013



commercial realities” and argued strongly that the Steer would not compromise the independence of the CMA.<sup>147</sup>

134. Three extracts are of particular relevance to the present paper. At the very beginning, the Steer indicated that the CMA should approach its analysis and remedies by focusing on consumer behavioural issues:

6 ...the CMA should take account of consumer behaviour particularly in markets where there are information problems and asymmetries. Markets sometimes fail to work effectively not because of lack of competition but because consumers struggle to compare products or face costs of switching. The Government considers that these consumer behavioural issues should be central to the CMA’s analysis of whether markets are working well, and where relevant, should inform the remedies it puts in place; (p 10)

The Steer then confirmed that the CMA should investigate the energy sector:

6 ... the CMA should assess specific sectors where enhanced competition could contribute to faster growth (for example, knowledge intensive sectors, financial services and infrastructure sectors including energy) – working with the responsible regulator where appropriate; (p 11)

Third, the Steer again directed the CMA to work with sector regulators:

9. The CMA is the single expert UK-wide competition agency and as such it has been given an important role to play in providing leadership across the economy and **working with and through partner agencies** to deliver positive competition outcomes: (bold in original)

the CMA should engage in a broad strategic dialogue with the regulators and look for opportunities to promote effective competition through either carrying out its own work or actively supporting regulators’ analysis, enforcement and markets activity;

135. The CMA responded enthusiastically in the matter of consumer behavioural issues.<sup>148</sup> These concepts were also reflected in its *Guidance* on its approach to consumer protection issues.<sup>149</sup>

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<sup>147</sup> “Some have pointed to the strategic steer that Government has given us as a weakening of that independence. I could not disagree more strongly. ... it is important that any regulator, including the competition authority, is sensitive to both political currents and commercial realities. And it is important that there is a continued dialogue between the regulator and Government (as well as other stakeholders) on a “no surprises, no veto” basis. The strategic steer makes that high-level communication, which might otherwise be covert, open and transparent. The CMA must have regard to the steer, but is not bound by it.” David Currie, “The new Competition and Markets Authority: how will it promote competition?”, Beesley lecture, London, 7 November 2013. Also David Currie, “The case for the British model of independent regulation 30 years on”, Currie Lecture, Cass Business School, London, 21 May 2014

<sup>148</sup> Cf Alex Chisholm, “CMA: How we intend to use market investigations to extend the frontiers of competition”, speech at Regulatory Policy Institute Annual Conference, Merton College, Oxford, 9 September 2014. David Currie, “Homo economicus and homo sapiens: The CMA experience of behavioural economics”, speech given at New Zealand Commerce Commission public lecture, 20 April 2015; reprinted in Oxera *Agenda*, May 2015, 1-4. Both speeches have extensive discussions of behavioural economics, placing considerable emphasis on Oren Bar-Gill, *Seduction by Contract: Law, Economics and Psychology in Consumer Markets*, Oxford University Press, 2012.

<sup>149</sup> E.g. “3.6 Experience strongly suggests that competition and consumer policy are linked. Good consumer outcomes rely on competitive markets to provide choice and value, while vibrant competition relies on consumers confidently shopping around. Competition problems can often manifest themselves in businesses failing to comply properly with consumer protection laws, which in turn can prevent consumers driving effective competition and lower prices through the exercise of informed choice. 3.7 An understanding of consumer policy can help competition analysis through a better understanding of consumer detriment and how consumers interact with businesses. Lessons from consumer behaviour

### 23. Coordinating the CMA energy market reference

136. From the Government's perspective, it now remained to ensure that an energy market reference was made, and that the CMA and Ofgem at least started from a common understanding. Part One of this paper noted the joint involvement of Ofgem, the OFT and the CMA in the design of the *Assessment Framework*. How exactly did these parties come to be in that position?
137. On 29 July 2013 the Report of the Select Committee included a recommendation that Ofgem should publish an annual assessment of the effect its measures were having on competition and consumer engagement.<sup>150</sup> On 10 October, Ofgem agreed to do this. The Government said that it too was involved, commenting that "DECC and Ofgem have been working to improve competition in the domestic retail energy market. ... we are working closely with Ofgem to determine the content of this [assessment]."<sup>151</sup>
138. On 23 October, the Prime Minister promised "a proper competition test" of the energy market.<sup>152</sup> On 31 October the Secretary of State announced that the assessment "would be undertaken by Ofgem working closely with the OFT and CMA".<sup>153</sup> On 5 November Ofgem, OFT and CMA wrote to the Secretary of State noting that "The Government recently announced that Ofgem would work with the OFT and the CMA, as appropriate, in preparing a framework for the assessment of competition in energy markets and would then conduct that assessment."<sup>154</sup> The assessment would "build on work already carried out by Ofgem" and would also "build on existing and planned

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can inform how remedies are likely to work in practice and whether they will be effective. Useful alternative or additional remedies to competition problems can sometimes be found in the consumer toolkit. For example, activating consumer choice by increasing suppliers' obligations to disclose information in combination with increased consumer awareness can kick-start markets where there is a lack of competition." *Consumer protection: Guidance on the CMA's approach to use of its consumer powers*, CMA7, March 2014

<sup>150</sup> *Energy Prices, Profits and Poverty*, House of Commons, Energy and Climate Change Committee, 5th report, Vol 1, 29 July 2013, para 42. Ofgem had earlier committed to monitoring the effect of its RMR proposals at the time it announced them.

<sup>151</sup> House of Commons, Energy and Climate Change Committee, 5th report, *Energy Prices, Profits and Poverty*, Government and Ofgem responses, 10 October 2013 p 7.

<sup>152</sup> In answer to a question from Edward Miliband (Leader of the Opposition and former Energy Secretary), the PM said "I can tell the House today that we will be having a proper competition test carried out over the next year to get to the bottom of whether this market can be more competitive. ... We need an annual audit of competition to make this market more competitive.... and to roll back the costs imposed on people's energy bills..." *Hansard* 23 October 2013, Columns 293-5

<sup>153</sup> "As the Prime Minister announced last week, we now propose to introduce annual reviews of the state of competition in the energy markets. And the first of these new competition assessments will be delivered by Spring next year. The assessment will be undertaken by Ofgem working closely with the Office of Fair Trading and the Competition and Markets Authority, when it comes into being. The exact metrics for the review will be a matter for the regulators but I will be asking them to look in depth and across the energy sector at profits and prices, barriers to entry and consumer engagement." Edward Davey, Secretary of State for Energy and Climate Change, *Annual Energy Statement 2013*, oral statement to Parliament, 31 October 2013.

<sup>154</sup> *Competition in energy markets*, Letter from Ofgem, CMA and OFT to Secretary of State for Energy and Climate Change, 5 November 2013

cooperation between Ofgem and the OFT/CMA”.<sup>155</sup> On 12 December CMA contacts joined GEMA for a working lunch.<sup>156</sup> The joint *Assessment Framework* was published on 19 December. The joint *Market Assessment* itself followed in March 2014, at which time Ofgem announced its provisional intention to make a market investigation reference to the CMA.

139. Thus, following its ongoing close working relationship with Ofgem, its creation of the CMA and its Steer to the CMA, the Coalition Government brokered a period of cooperation between Ofgem, the OFT and the CMA to determine the framework for assessing competition in the energy market and then to assess the extent of competition itself. This final step before Ofgem made the reference secured a commonly agreed and authoritative analysis of the problems with the energy market, with which the subsequent CMA inquiry group could begin.

#### **24. Impact of the Steer on the CMA energy market reference?**

140. Part One of this paper asked whether Ofgem’s joint work with the CMA before the reference was made gave Ofgem an undue influence on the CMA investigation of the energy market. Part Two has explained the evolution of Government policy including the steps that the Government took to guide the policies of both Ofgem and the CMA. This raises the question of what is meant by ‘undue’.

141. The CMA explains that each inquiry panel comprises independent members who make up their mind based on the evidence put before them. There is no reason to doubt this.

142. However, put simply, from the then-Government’s perspective, the whole *purpose* of the prior arrangements was to give Ofgem undue influence in a CMA investigation. The process was not designed to start from scratch with an open mind. The Coalition Government took the view that Ofgem’s role was to help deliver the Government’s policy outcomes. The Strategy and Policy Statement was intended to make this explicit, but in any case the Government had worked closely with Ofgem to design the latter’s policy. In parallel, the Government also created the CMA for the same purpose: to bring the OFT and CC into closer harmony to help deliver the Government’s overarching policy objectives. The latter were reflected in the Steer, which encouraged the CMA to investigate the energy sector and specified that it should make consumer behavioural issues central to its analysis and remedies. The Steer also required the CMA to work closely with Ofgem, which had been led in the same direction. The CMA’s 2013 *Guidelines* reflect this guidance, for example in their focus on behavioural economics and weak customer

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<sup>155</sup> Presumably the “planned cooperation” envisaged that some of Ofgem’s case study team could be seconded to the CMA (*Market Studies and Market Investigations: Supplemental Guidance on the CMA’s Approach*, CMA 3 January 2014). The *Memorandum of Understanding* of 11 August 2014 would provide for “promoting co-operation and coordination between the CMA and OFGEM when dealing with market studies and market investigation references”. See also Littlechild (April 2014) 198-200.

<sup>156</sup> Minutes of a Meeting of GEMA, 12 December 2013, para 3.

response. Finally, to minimise the possibility of lack of coordination, the Government brokered joint work between Ofgem, the OFT and the CMA to determine an *Assessment Framework* and the *Competition Assessment* itself.

143. The CMA and Ofgem arrived at essentially the same diagnosis of the retail energy market. Both diagnoses are based firmly on consumer behavioural issues and the concept of weak customer response, and possible remedies oriented around seeking to make customers more active. From the Government's perspective, this was no accident: it *meant* the CMA to look at the market from Ofgem's perspective, and to work with it to implement Ofgem's policy, because Ofgem's policy was the Government's policy. Ofgem's vision was the Government's vision. From the Government's perspective, the task of both Ofgem and the CMA was to help deliver it. Ofgem and the CMA were given the same hymn sheet to sing from, a hymn that Ofgem had been encouraged to sing for years, and they were handcuffed together until they arrived at the church. Of course, the CMA panel consisted of independent members, who would make up their own minds in the light of their statutory duties. So it was open to the CMA panel to sing a different hymn, but the ceremony was not designed with that in mind.
144. The second question raised in Part One concerned the CMA's definition of a well-functioning retail energy market in explicit terms, associated with desired outcomes and Ofgem's vision of a successful energy market. Is this consistent with the CMA's remit under the Enterprise Act 2002 to focus on competition issues rather than (unspecified) public interest issues? Or is the CMA investigation being used to achieve public interest goals that are different from what a competitive market would realistically entail?
145. This is no doubt a matter for lawyers to opine on, but it would seem on the face of it that the latter was precisely the purpose of the then-Government's Steer to the CMA. The Government's vision, its over-arching objective, was not merely a more competitive market. It was a particular kind of competitive market, characterised by more active and better informed customers, and characterised by outcomes that would be fairer, or less unfair, to particular groups of customers relative to others.
146. In other words, without making a formal public interest reference as provided for under the Enterprise Act 2002, the purpose of the Steer was to convey to the CMA the Government's view of the public interest with respect to the operation of markets, a view that it had taken pains to ensure Ofgem was aware of. The Steer called on the CMA, in discharging its obligations under the Enterprise Act 2002, to have regard to this view. In this sense there would seem to be a tension between the received aim of the Enterprise Act 2002, namely to remove public interest considerations other than competition, and the Enterprise and Regulatory Reform Act 2013, which provided for the Steer precisely in order to reintroduce such considerations.
147. The Enterprise Act 2002 may thus have put an end to 'substantial room for the exercise of political preferences', but only for some 11 years. By 2013 political preferences were back, but this time defined by the politicians in

Government rather than left to the preferences of individual competition authority inquiry groups.

## 25. Did the Steer made a difference?

148. There is an important qualification to the above discussion. Even if the CMA's *Provisional Findings* and *Possible Remedies* are consistent with the Steer, and with what the Coalition Government was hoping to achieve, were they actually the result of the Steer? And if they were, would that have been inappropriate? There is no reason to doubt that members of the CMA energy inquiry panel made up their mind independently on the evidence before them. In the respects mentioned above, their *Provisional Findings* and *Possible Remedies* are consistent with the Steer, but we do not know whether the panel members had significant regard to the Steer, or read it then forgot it, or totally ignored it. Nor do we know how far they were influenced by the 2013 *Guidelines* (though they do refer to them), by behavioural economics or by other considerations.

149. Experienced regulatory colleagues have argued that regulators and competition authorities are guided by their statutory duties and not by non-statutory steers or guidance. Such steers and guidance are typically of a 'motherhood and apple pie' nature, designed for consumption by the media rather than by these authorities, and not likely or intended to prevent the authority from doing what it would otherwise choose to do.<sup>157</sup>

150. Certainly the Labour Government's first Environmental and Social Guidance to Ofgem was seen in this way. The CMA chairman perhaps indicated as much with respect to the Steer.<sup>158</sup> If this is the case, it implies (inter alia) that deciding to investigate the energy sector, working with sector regulators like Ofgem, and making consumer behavioural issues central to its analysis of whether markets are working well and to its proposed remedies, would be integral to CMA thinking without the injunction in the strategic Steer.

151. How far does that seem likely? Take the three aspects in turn. First, given the public controversy about the energy sector, it is entirely plausible that the CMA would have investigated it, regardless of the Steer. Second, working with sector regulators is perhaps a matter of degree: Part One

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<sup>157</sup> For a considered discussion of related issues, see William Kovacic, "Competition agencies, independence, and the political process" chapter providing background material for the Roundtable on Changes in Institutional Design of Competition Authorities, OECD Competition Committee, 17-18 December 2014. This is an extract from Josef Drexler, Wolfgang Kerber and Rupprecht Podszun (eds), *Competition Policy and the Economic Approach*, Edward Elgar, 2011. Portions of the chapter are adapted from William Kovacic, "Congress and the Federal Trade Commission", *57 Antitrust Law Journal* 517(1989). He argues that "The question is not whether competition agencies operate in an environment that features political pressure. Most certainly do. ... The real issue is how the competition agency ... can deflect political pressure..."

<sup>158</sup> "[W]ere we to be steered to an issue which we judged to be without substance, then the CMA Board would be obliged to explain in public why we reached that view – that is the transparent way that independence would be asserted. But given the high-level and well-positioned nature of the current steer, I would be very surprised if that were necessary." Currie (November 2013)

suggested that the CMA was more receptive to Ofgem's thinking than the CC was to the CAA's thinking; the explicit well-functioning market reflected Ofgem's (and the Government's) vision; the assumption that a well-functioning market would have efficient costs is unique to this investigation and directly from Ofgem; and the pre-reference coordination with Ofgem to agree an assessment framework is probably a first. It is not clear that the CC would have done all this. Third, making consumer behavioural issues central to analysis and remedies is debateable: on the one hand it is a rather specific and unprecedented direction, but on the other hand it reflects then-Government policy generally and increasing enthusiasm for such an approach amongst regulatory and competition authorities, not least the OFT. The next section briefly examines further this changing emphasis in market investigations.

## 26. The changing nature of market investigations

152. Consider the frequency with which the CC, CMA and Ofgem mention a few key words that may reflect how they approach consumer behavioural issues. For example, a new concept is that a well-functioning or competitive market requires customers to trust their suppliers and switching sites, and even the market generally. This concept of trust is not mentioned in the 2003 or 2013 *Guidelines* so it was presumably not much used by the CC. However, it appears in the *Probe Initial Findings* 7 times, in the *RMR Findings* 12 times, in the *Market Assessment* 26 times then in the *CMA Provisional Findings* 43 times. The *Private Banking Provisional Findings* mention it only a couple of times (plus distrust 3 times). This suggests that the CMA *Energy* panel's use of trust as a consumer behavioural issue is heavily influenced by Ofgem's advocacy of it.<sup>159</sup>
153. Customer engagement is a key consumer behavioural issue, consistent with the Coalition's over-arching emphasis on "confident consumers, who are adept at exercising choice". Again, it is not mentioned in either the 2003 or 2013 *Guidelines*. However, it appears in the *Probe Initial Findings* 49 times, in the *RMR Findings* 76 times, in the *Market Assessment* 94 times then in the *CMA Provisional Findings* 288 times and in *Retail Banking Provisional Findings* 167 times. This suggests that focus on customer engagement too has been greatly stimulated by Ofgem's advocacy, but that interest in it extends more broadly.
154. Weak customer response is a concept that seems to have been created by the 2013 *Guidelines*, where it is mentioned for the first time. It appears at most once or twice in previous CC investigations. In contrast, it appears 35 times in *Energy* and 38 times in *Retail Banking*.
155. Finally, consider the notion of customers switching suppliers or products. This is indeed increasingly discussed in the *Guidelines*: 38 mentions

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<sup>159</sup> Whether energy suppliers and banks are less trusted than the average business is an interesting question. A recent poll puts public trust in business leaders generally at 35% compared to doctors at 89%. (Ipsos MORI, cited in *The Times* January 22, 2016 p 5) But bottom of the poll are politicians 21% and government ministers 22%, even below estate agents 25%. Perhaps governments might more usefully focus their trust-building efforts closer to home?

in 2003 and 89 in 2013. CC investigations mention it an average of 137 times in the Provisional Findings and 204 times in the Final Report, an intriguing increase of about 50% from Provisional to Final (although average page length increases by only 5%). The highest number of mentions is in *Personal Current Accounts NI*: 333 times in the *Provisional Findings* and 621 times in the *Final Report*.

156. Ofgem in energy, and the previous CC investigation into banking, seem to inspire the CMA to new heights of enthusiasm. The *Probe Initial Findings* mention switching 574 times, the *RMR Findings* 122 times, the *Market Assessment* 130 times, then the *CMA Provisional Findings* 478 times. In *Retail Banking Provisional Findings* it appears no less than 686 times. If the increase to final report is about 50% as in the past, the *Energy* report might have over 700 mentions and the *Retail Banking* over 1000. Although customer switching has long been used by the Commission, it seems that the CMA is significantly accentuating its emphasis on the concept. Would it be unfair to say that customer switching has become a CMA obsession?

157. The CMA has provisionally found that there is weak customer response in the retail energy and banking sectors, and that this has adverse effects on competition. But this does not necessarily indicate that these markets are less competitive and customer sensitive than they used to be, or than other consumer markets that the CC has examined in the past. Rather, markets, suppliers and customers are being tested against different criteria. The goal posts have been moved. No doubt the CMA inquiry panels are taking independent views about these markets, but they are different views from those taken previously by the independent CC inquiry panels. They seem to reflect many influences, including the consumer behavioural issues highlighted in the OFT's 2010 paper and the CMA's *Guidelines*, perhaps the role of the former OFT within the new CMA, the Coalition Government's advocacy of active and informed consumers as reflected in its strategic *Steer*, and also the growing enthusiasm for behavioural economics among regulatory and competition authorities generally.

### **PART THREE: THE TIMES THEY ARE A-CHANGING?**

#### **27. Policy of the Conservative Government (May 2015 to date)**

158. The present Conservative Government was elected on 7 May 2015. The new Secretary of State for Energy and Climate Change was broadly supportive of the CMA's *Provisional Findings* and *Possible Remedies*.<sup>160</sup> She referred to the Government's concerns about switching and vulnerable customers, and "the importance of taking action in particular to protect unengaged consumer". But her support for action to prompt unengaged consumers could be read as cautioning against over-simplicity.<sup>161</sup>

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<sup>160</sup> Amber Rudd, *Letter to CMA*, DECC 31 July 2015

<sup>161</sup> "Tackling the issue of unengaged consumers is a very challenging one that will require a number of different angles of attack. Designing effective prompts to consumers to engage in the market will require careful consideration and input from behavioural and commercial experts, as well as testing with consumer panels. Your enquiry is an opportunity to develop and put in place the interventions that

159. In November 2015 the Chancellor of the Exchequer and the Secretary of State for Business, Industry and Skills outlined their *Better Deal* approach to competition.<sup>162</sup> They declared that “well-functioning markets are the lifeblood of a thriving economy.” (p 3) This meant “ensuring consumers have the unbiased information they need to be confident and secure in exerting their buying power, driving markets to deliver for them”. (p 3) But greater emphasis than before was placed on “removing barriers – including unnecessary regulation – that stop small and innovative businesses from growing and exploiting market opportunities”. (p 3)
160. On 2 December 2015 the Secretary of State for Business, Industry and Skills published a revised Steer for to the CMA, following a consultation initiated in July.<sup>163</sup> The focus is still on promoting competition, of course, but the revised Steer is different from the Coalition Government’s Steer in significant respects. The Introduction explains that “This Steer places more of an emphasis on productivity and removing obstacles that prevent new, innovative business models from entering the market place.” (p 3) Consistent with that, the Steer begins by declaring that “the CMA should ensure that dynamic competition is allowed to flourish, thereby increasing productivity and sustaining economic growth for the benefit of consumers”. (p 9)
161. Consider the three points highlighted in the previous Steer.
- There is an acknowledgement that “The CMA should consider consumer behaviour and actions when assessing whether a market is operating properly, looking at issues such as failure to compare products.” (p 9) Importantly, however, the revised Steer removes the paragraph telling the CMA that consumer behavioural issues should be central to the CMA’s analysis and should inform the remedies it proposes.
  - The Government no longer proposes to tell the CMA which sectors it should assess.
  - The CMA is still expected to play a leadership role with respect to sector regulators. However, the reference to “actively supporting regulators’ analysis, enforcement and markets activity” is deleted. The stance towards regulators and regulation is now quite different.
 

“The Government is committed to removing unnecessary regulatory burdens on businesses wherever possible. Using competition tools can often provide an alternative to regulation, and we encourage the CMA to act as a leader in this regard, particularly with sector regulators. The CMA can play a significant role in reducing burdens on businesses and securing better outcomes for consumers by: ... partnering with economic regulators to use effective competition

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should ensure that the market operates for the consumer on a sustainable basis. I know you will be assessing carefully the impact of your proposed remedies (in full or in part) on the market issues you have identified.”

<sup>162</sup> *A better deal: boosting competition to bring down bills for families and firms*, Cm 9164, November 2015

<sup>163</sup> *Government’s response to the Consultation on the Strategic Steer to the Competition and Markets Authority*, BIS, 2 December 2015.



tools to promote changes in markets rather than prescriptive licensing conditions and regulatory requirements;” (pp 10-11)

162. Clearly this is a different Steer from the previous one. How far it reflects a substantial and ongoing change in competition and regulatory policy remains to be seen. But what are the initial implications for the CMA itself and for the individual inquiry groups? The latter have been given new hymn sheets. How should they sing?

## **28. Implications for the CMA energy market investigation**

163. The ongoing CMA market investigations were started under the previous Steer, and on that basis have reached provisional conclusions. There are obvious difficulties about changing course during an investigation. However, in past investigations the Commission has changed its view from its provisional conclusions to its final conclusions. The following three considerations suggest that the CMA energy market inquiry group should indeed respond.

164. First, the CMA chairman has said (fn 147 above) that “it is important that any regulator, including the competition authority, is sensitive to both political currents and commercial realities”. The UK political situation has changed significantly since the original Steer was put in place and the CMA began its energy market investigation. There is no reason to believe that customers, politicians, ministers and the media are less concerned about energy prices or less suspicious of the large energy companies. However, in May 2015 the electorate voted decisively against the Labour and Liberal Democrat parties that had been implementing, advocating and supporting various regulatory interventions in the market since 1997. There is thus every reason for the CMA to be sensitive to the political current reflected in the new Steer.

165. Second, the guidance in the new Steer is not just a different political current. It reinforces advice that independent economists and others, including former energy regulators, have been giving the CMA during the course of this investigation.

166. Third, as illustrated in more detail below, the new Steer is consistent with evolving evidence and thinking about consumer behavioural issues, and behavioural economics generally. This suggests that these issues are more complex than at first seemed, and less suitable to be “central” to the analysis and remedies than the first Steer recommended.

167. If the CMA Energy market investigation had been given the present Steer at the beginning, it might have started the retail market analysis with the various regulatory interventions, then looked at whether customer response would have been problematic in their absence, rather than treated regulation as an add-on to received analyses from Ofgem and the joint *Assessment* that focused on weak customer response and ignored regulatory interventions. However, that is water under the bridge. What could and should the CMA

Energy market investigation realistically do at this stage to be sensitive to the current reflected in the new Steer? Here are four suggestions.

168. (1) In considering remedies for any adverse effects on competition, the CMA should be particularly conscious of the implications for regulatory burdens and for dynamic competition. This should make the CMA more sceptical of the case for further remedies based on intervening to change customer behaviour, and should surely rule out a return to price control, whether for a large or small class of customers.
169. (2) The CMA should examine more closely the present and previous regulatory interventions in the energy market, arguably more restrictive and burdensome than any regulatory intervention in any UK market to date. It should ask which of these regulatory interventions had positive, negative or negligible impacts on competition and customers. It should try to quantify these effects, to assess how much they have increased prices and profits and reduced customer engagement. It should look more thoroughly at those interventions rather brushed aside in the *Provisional Findings*, notably the non-discrimination condition and the marketing condition, and those not really examined at all, such as the regulatory obligations and restrictions on provision and presentation of information. The point of this examination would be to understand better how far present market conditions reflect intervention rather than underlying market forces, to assess how far removing those interventions could help the market work better for customers, and to identify further regulatory interventions whose removal might have a similar beneficial effect.
170. (3) Noting that “actively supporting regulators’ analysis” is no longer part of the current Steer, the CMA should consider whether its present analysis of the market, and the joint *Assessment* that informed it, are unduly focused on consumer behavioural issues. Does observed behaviour really reflect weak customer response to the extent initially conjectured, or might it not reflect customer preferences to a greater extent than allowed? Is this perspective trying to force more customers to become more active and engaged than they really want to be? Has the CMA’s definition of a well-functioning retail energy market been unduly driven by Ofgem’s ‘vision’ or by the political goals of (part of) the Coalition Government?
171. (4) The CMA should revisit its calculations of excess charges in the sector, and particularly its assumption that, in a well-functioning market, prices would be equal to efficient cost. At the moment the calculations are hidden, the methodology has no Commission or other precedent, its origin lies in a suggestion by Ofgem, and it has no sound economic basis. It is in danger of becoming the CMA’s dodgy dossier. The CMA needs to establish whether the major suppliers have made excess profits in the conventional sense – and, importantly, whether they would have made excess profits in the absence of regulatory interventions that the CMA has provisionally found to have restricted competition. Or, alternatively, is the problem essentially that differentials in prices and profits raise issues of fairness as between different

classes of customers in a market that is broadly competitive - in other words, a public interest issue?

172. In sum, the CMA's revised approach to the energy market investigation could and should stand back from the previous injunction to make consumer behavioural issues central to its analysis and remedies, and focus more on traditional competition issues, then as appropriate "removing unnecessary regulatory burdens on businesses wherever possible", thereby "allowing dynamic competition to flourish ... for the benefit of customers".<sup>164</sup>

## 29. Implications for the CMA generally

173. The CMA's recent consultation on its Annual Plan devotes six paragraphs (out of about 100) to the Better Deal and the strategic Steer combined.<sup>165</sup> It sees "a close fit between the Steer and our own emerging plans for next year". (para 1.15) There is no acknowledgement that in certain critical respects the new Steer is significantly different from the previous one, so it is unclear whether or not the new Steer has influenced the CMA's emerging plans.

174. If the CMA is to have regard to the new Steer, it might wish to consider where and how to do so. Presumably corporate CMA decisions about focusing effort and resources, deciding on investigations, and developing *Guidelines* should have regard to it. Presumably, too, individual panel inquiry groups should have regard to it. In due course it will be interesting to have the CMA's assessment of whether the previous Steer made any difference to the CMA's work to date, perhaps compared to the previous CC investigations. What further differences might then be expected as a result of the change in the Steer? If the Steer itself is to be "open and transparent", should the CMA's response(s) to the Steer be too?

175. If an ongoing investigation needs to consider the implications of a new Steer, and potentially new *Guidelines*, does the CMA need to consider whether investigations should be started within a year or so of an election? The CMA and policymakers generally might also wish to consider the pros and cons of having a competition authority subject to a constantly changing Steer, and indeed subject to a Steer at all. Might the preference for particular kinds of competition, as suggested above, represent a potential conflict with the Enterprise Act 2002? Is the creation of a Steer a practical consequence of giving a competition authority freedom to take action rather than simply to advise? Which set of arrangements, on balance, is preferable?

176. It is suggested above that the 2013 *Guidelines* reflected the (then-prospective) Steer, or at least turned out to be very consistent with it, and also reflected the OFT's focus on behavioural economics. Both influences are particularly notable with regards to the *Guidelines* emphasis on weak customer response, which parallels the Steer direction to analyse markets and remedies

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<sup>164</sup> As the former energy regulators have argued. Littlechild et al, "The new Government Steer to the CMA", submission to the CMA, 14 January 2016

<sup>165</sup> *CMA Annual Plan consultation 2016/17*, CMA52con, December 2015, paras 1.10-1.15

in terms of consumer behavioural issues. The new Steer no longer requires this. The emphasis now is on removing unnecessary and burdensome regulation. Surely the *Guidelines* need to be revised to reflect both changes?

177. To illustrate, it was shown above that customer switching has been a continued interest for the Commission, and the *Energy Provisional Findings* mention the concept 478 times. But whereas some customers like switching, and others might wish to switch but are deterred for one reason or another, surely yet other customers prefer not to switch because that is not their preferred way of life. Is there not merit in suppliers seeking to encourage customer loyalty that reduces or obviates the need to switch supplier? Yet Ofgem's policy is to prohibit loyalty discounts, and the CMA sees no reason for customers to prefer one energy supplier over another. Customer loyalty gets only a brief mention in the 2003 and 2013 *Guidelines*, and then only because it is construed as a restriction on switching. It is mentioned only once each in the *RMR Findings*, *Market Assessment* and *CMA Provisional Findings*.<sup>166</sup> Does a switching: loyalty ratio of nearly 500:1 represent a proportionate analysis of energy customer behaviour? Revised *CMA Guidelines* might usefully consider the question of balance.

178. Actually, the issue goes deeper. (Littlechild April 2014, 192-4) The 2013 *Guidelines* assert that "competition can be threatened" where "customers may lack information about what product to choose, may not be able to judge between different products on offer" (para 15) or if "customers respond weakly to competitive offers" (para 295). Following the OFT's lead, the *Guidelines* list all the prerequisites that customers need to fulfil "to drive effective competition". But this approach sees competition as a mechanism that works properly only with informed, rational and active customers, not as a process that actually works in the real world. It fails to appreciate that alerting and incentivising otherwise unaware or disengaged customers, for example by marketing and advertising, is an integral part of competition as a rivalrous process over time.

179. In addition, economic analysis suggests that price discrimination or price differentials may be a manifestation of competition rather than the lack of it; that competition to secure "sticky" customers may reduce rather than increase prices; and that attempts to increase customer engagement may impact on relative prices rather than absolute prices. At the Select Committee hearing in 2008 Allan Asher recognised this last point well.<sup>167</sup> This brings the focus back to behavioural economics.

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<sup>166</sup> It might be said that energy suppliers have failed to build reputations for customer loyalty as grocery suppliers have. But the GB retail energy market is not yet two decades old, and the new suppliers not yet one decade, whereas most of the major GB supermarkets were founded between one and one and a half centuries ago. (Foundation dates: Tesco 1919, Aldi 1919, Morrisons 1899, Marks & Spencer 1884, Sainsbury's 1869, Waitrose (John Lewis Partnership) 1864, Co-operative Group 1844) The CMA's *Guidelines* commit it to considering the effects and expected development of competition over time. Has it allowed sufficient time for different aspects of retail energy competition to develop?

<sup>167</sup> It was put to him that "In theory, I suppose if we could persuade every single consumer, where possible, to switch to the cheapest supplier, that would drive down the market price." He replied, "In theory it would not, because what would happen is the prices would then be redistributed as the

### 30. Behavioural economics revisited

180. The CMA might wish to consider whether it would be timely to revisit the OFT's 2010 paper on behavioural economics. That paper was commendably balanced in terms of identifying both potential advantages and limitations of using behavioural economics, as indeed have been the speeches of Chisholm and Currie (fn 148 above). There is now a large and ever-growing literature on the subject, not least examining how regulators have used behavioural economics and what effects their measures have had. This suggests that behavioural economics still has powerful and important implications, with scope for helpful regulatory action.<sup>168</sup> However, it also has serious potential downsides, which suggest that the reduced emphasis on consumer behavioural issues in the new Steer may be appropriate. The following observations do not purport to cover the whole field, but rather draw attention to some recent concerns about behavioural economics approaches that suggest a reconsideration of the implications for regulatory and competition authorities.

181. The FCA was enthusiastic about behavioural economics, which “enables regulators to intervene in markets more effectively, and in new ways ...”<sup>169</sup> The former Chief Executive observed that “Today, regulators use vastly more advanced technology than Neil Armstrong used to reach the moon.”<sup>170</sup> He envisaged using this to model customer (and supplier) behaviour in some detail. The FCA has also found via randomised control trials that some nudges have no effect and others (like putting the Chief Executive's signature at the bottom of a customer letter) have a negative effect. Wisely, it has recommended trialling further nudges before taking more widespread action.<sup>171</sup> However, some important policies evidently proceeded without prior trialling, and have led to problems and customer resistance.<sup>172</sup>

182. Ofgem's 2008 and later interventions inspired by behavioural economics were of a greater order of magnitude and were not trialled beforehand. The CMA has not detected significant beneficial effects, and has provisionally found that in important respects the interventions have had

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companies gained their revenue across a wider base but, nonetheless, a certain amount of switching will discipline prices.” Q220, Ev 28

<sup>168</sup> For a good and realistic discussion applied to the energy sector, see Michael G Pollitt and Irina Shaorshadze, “The role of behavioural economics in energy and climate policy,” ch 24 in Roger Fouquet (ed), *Handbook on Energy and Climate Change*, Edward Elgar, 2013.

<sup>169</sup> Introduction by Martin Wheatley to Kristine Erta, Stefan Hunt, Zanna Iscenko, Will Brambley, *Applying behavioural economics at the Financial Conduct Authority*, Occasional Paper No. 1, April 2013.

<sup>170</sup> Martin Wheatley, “Economics, technology and data – Redefining the future of conduct regulation”, Beesley lecture, London 14 November 2014

<sup>171</sup> A view shared by the NAO, which has recently recommended that “The CMA and regulators should: Develop further their understanding of consumer behaviour to inform proposed remedies. This should include greater testing of remedies before implementation, ...” National Audit Office, *The UK competition regime*, HC 737, Session 2015-16, 5 February 2016, p 12.

<sup>172</sup> For a recent popular protest, see “‘Liar loans’ are back – and a good thing too. Britain's intrusive borrowing rules are paralysing the mortgage market and infantilising us all. Now there's an alternative”, Libby Purves, *The Times*, January 25, 2016 p 23.

substantial adverse effects.<sup>173</sup> On a realistic view, Ofgem's post-2008 interventions have been a failure.

183. Regulatory interventions inspired by behavioural economics are evidently not straightforward.<sup>174</sup> Economists are now beginning to analyse in detail the effects of some interventions. They have found that, once competitive market reactions are allowed for, even the most plausible and least intrusive interventions can be problematic. For example, in the US telecoms sector, there was concern about customers hit by "bill-shock" when they exceeded the number of calls in their purchased package. Suppliers were required to give such customers advance warning. In the event, on average this made customers worse off.<sup>175</sup> Other recent studies have found similar adverse outcomes.<sup>176</sup>

184. The economic analysis of behavioural economics and its implications for policy is firmly based on conventional equilibrium analysis. The Introduction to the 2010 OFT paper on behavioural economics says that "It examines the implications of consumer behavioural biases for firms' decisions and hence for competitive equilibria."<sup>177</sup> But equilibrium models can give a misleading picture. For example, what the OFT's literature survey calls "a modern classic" in behavioural economics finds that firms will systematically exploit unaware customers even with very intense competition.<sup>178</sup> This conclusion is based on an assumption that certain unaware customers can never learn. (Littlechild, April 2014, p 196) However, the authors accept that once "long-run dynamics" are considered, and customers learn to avoid add-on fees, this outcome no longer obtains. Other behavioural economic analyses have a similar limitation.<sup>179</sup>

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<sup>173</sup> *Provisional Findings*, paras 138-150, also critiques in fn 3 above and evidence in fn 47 above about lower customer switching and higher supplier profits.

<sup>174</sup> See for example the cautionary remarks in Behavioural Insights Team (BIT) response to Energy Market Investigation: Notice of Possible Remedies, 5 August 2015.

<sup>175</sup> Michael D Grubb and Matthew Osborne, "Cellular service demand: biased beliefs, learning and bill shock", *American Economic Review* 105(1): 234-71, January 2015. The study calculated that, if suppliers' prices remained unchanged, consumers would be on average \$103 per year better off as a result of such warnings, and suppliers' annual profits would be lower by \$196 per customer. However, suppliers would be expected to reduce their 'overage' rates (to encourage customers not to cut back usage), to reduce the number of minutes in the standard packages, and to increase the fixed fees for such packages. The study found that, after the bill shock provisions were put into effect, 2% of the customers terminated service and 25% of customers switched to larger and more expensive packages. Suppliers' profits remained about the same (a slight increase of \$7 per person), but consumer surplus fell by \$33 per person (about 4% of the average annual bill).

<sup>176</sup> "Our paper is one of the first empirical projects (see also Handel 2013) showing that equilibrium effects can undermine the potential benefits of Thaler and Sunstein (2008) – style 'nudges' designed to improve individual decision-making." (Grubb & Osborne, *op cit.*) Benjamin R Handel, "Adverse selection and inertia in health insurance markets: When nudging hurts", *American Economic Review*, 2013, 103(7): 2643-2682.

<sup>177</sup> *What does behavioural economics mean for competition policy?* OFT 1224, March 2010.

<sup>178</sup> Huck et al (2011) of X Gabaix and D Laibson, "Shrouded attributes, consumer myopia, and information suppression in competitive markets" (2006), 121(2), *Quarterly Journal of Economics*, 505.

<sup>179</sup> For example, one of the latest analyses "derives equilibrium prices in a competitive market and proves that optimally-calibrated price caps increase social welfare". Oren Bar-Gill, "Price caps in multi-price markets", *Journal of Legal Studies*, 44, 2015 (forthcoming). The paper acknowledges that "Such price regulation would be less effective in markets where sellers can easily 'invent' additional

185. Behavioural analyses typically suggest that the competitive market cannot work to meet the needs of customers, so regulatory intervention is required. But this can be an artefact of an equilibrium model of competition, inconsistent with the model of competition as a dynamic, rivalrous discovery process that the CMA professes to accept. Competition, properly understood, may be better able to deal with some “customer biases” than these models allow.<sup>180</sup> The *Guidelines* could usefully be revised to acknowledge this.<sup>181</sup>

186. Behavioural economists have argued convincingly that, in many respects, real consumers are not the rational, perfectly informed, utility maximising actors assumed in conventional (neo-classical) economic theory. But instead of developing an economic theory that better reflects how real consumers do behave, the focus has been on trying to make real people act in the way that the theoretical models assume. That is, the focus has been on trying to change human behaviour, maybe even human nature. Not surprisingly, this has proved difficult.

187. Who could and should change customer behaviour? If regulatory and competition authorities are subject to behavioural bias as consumers are, can it be assumed that such bodies can and will perform this task satisfactorily? Cooper and Kovacic alert us to the implications, including a tendency to adopt politically expedient policies.<sup>182</sup> Their conclusions are striking and sobering, and in contrast to the recommendations of many behavioural economics papers.

Much BE [Behavioural Economics] research prescribes increased regulatory intervention to constrain consumer choice in response to consumer biases and to expand use of competition law to correct consumer harm that arises from

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price dimensions that would trigger similar misperceptions” - that is, in the real non-equilibrium world where competition is a rivalrous discovery process.

<sup>180</sup> This point is well made in the balanced appraisal by Allan Fels and Henry Ergas, “Institutional design of competition authorities”, Roundtable on Changes in Institutional Design of Competition Authorities, OECD Competition Committee, 17-18 December 2014, pp 8-10

<sup>181</sup> For example, the *Guidelines* discuss the potential adverse effects on competition that arise from information asymmetries, where customers are not able to gauge the quality of a service when acquiring it. They note that these effects might be mitigated in various ways, including by Government standards and certification, liability laws, regulation of entry, advice of an independent expert, and warranties or guarantees. (paras 311 – 315) There is no recognition that the most widespread and effective mitigation is the operation of the competitive market, whereby rival firms have the incentive to inform customers about limitations of the goods or services provided by others as well as the quality of their own products.

<sup>182</sup> “We find (unsurprisingly) that flawed heuristics (e.g., availability, representativeness, optimism, and hindsight) and myopia are likely to lead regulators to adopt policies closer to those preferred by political overseers than they would otherwise. ... We conjecture that confirmation bias may create a weak tendency to adopt politically expedient policies given that the first piece of evidence a regulator views on a matter likely will be a call to action. ... we argue that the incentive structure for regulators is likely to reward those who adopt politically expedient policies, either intentionally (due to a desire to please the political overseer) or accidentally (due to bounded rationality). These incentives are likely to yield a cadre of regulators who focus excessively on outputs rather than outcomes. Our analysis suggests that careful thought be given to calls for greater state intervention ...” (pp 42-3) James C. Cooper & William E. Kovacic, “Behavioral Economics: Implications for Regulatory Behavior”, *Journal of Regulatory Economics*, 41(1), February 2012: 41-58. (See also William E Kovacic and James C Cooper, “Behavioural economics and its meaning for antitrust agency decision making, *Journal of Law, Economics and Policy*, 4(8), 2012, 779-800, adapted in part from the previous article.)

biased firm behavior. If regulators, who are human after all, suffer from the same biases, our analysis suggests a greater skepticism of these calls for increased intervention. Although regulators are likely to have an edge over consumers in terms of experience and expertise, it is unclear that they will be able to intervene in ways that systematically improve welfare. The model we present shows that political pressure will cause rational regulators to choose policies that are not optimal from a consumer standpoint, and that in many circumstances regulatory bias will exacerbate this tendency. (p 56)

188. If regulators are subject to the same biases as consumers, is a Regulatory Conduct Authority needed, to try to make regulators act rationally?<sup>183</sup>

### 31. Concluding remarks

189. The CMA's *Energy* market investigation is the fourth set of analyses and proposals concerning the GB retail energy market in the last eight years. In each previous case the pattern of events is similar: consumer bodies and smaller competitors express concern at increasing retail energy prices and/or price differentials set by major suppliers; the relevant Energy Select Committee endorses this concern; Government echoes this concern and works with Ofgem, which proposes tough new measures on major suppliers; Government strongly supports these measures and takes reserve powers in new legislation to impose such measures in order to discourage resistance and delay by major suppliers. But the measures do not solve the problem, there is repeated concern, and the pattern of events begins again.

190. It was hoped that the CMA reference would be an independent and authoritative inquiry that would establish once and for all whether there really was a problem in the retail energy market. Yet the CMA diagnosis and remedies seem so similar to those of Ofgem. This paper tries to understand why this has been the case. It suggests that factors involved include the involvement of Ofgem in the process leading up to the CMA investigation, the policies of the Labour and Coalition Governments, particularly as expressed in the latter's strategic Steer to the CMA, and the increasing influence of behavioural economics on regulators and competition authorities, including as reflected in the CMA *Guidelines*. Dynamics within the CMA might also be relevant: the CMA is after all the successor body to the OFT as well as the CC.<sup>184</sup>

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<sup>183</sup> *Applying behavioural economics at the Regulatory Conduct Authority*, Occasional Paper No 1, Regulatory Conduct Authority, 1 April 2014, available at [www.eprg.group.cam.ac.uk](http://www.eprg.group.cam.ac.uk). This paper (published on April 1) essentially takes FCA Occasional Paper No 1 (Erta et al 2013) and substitutes the word regulator for consumer.

<sup>184</sup> It seems from the Annual Reports that, in relevant respects, former OFT professionals in the CMA might exceed former CC professionals by about two to one. Taken together with the 'streamlining' of the CMA, which involves transferring people who worked on the initial market studies to the market investigation, this suggests that the CMA would significantly reflect 'OFT culture' as well as (or even more than) 'CC culture'.



191. This paper opened with a speech by the CMA Chief Executive and can aptly close with one of his latest speeches.<sup>185</sup> As always, it is thoughtful, succinct, elegant, well-informed, and persuasively presented. It argues that under-active banking and energy consumers – the “sleepers” – reduce competition to the disbenefit of other consumers, notes that CMA investigations have further remedies in hand derived from behavioural economics, and cites Nobel Prizewinners Akerlof and Shiller in support of this approach.
192. There is another perspective, however. Sleepers may be annoyed rather than grateful to be disturbed. To date, the multiple behavioural remedies in both energy and banking markets have been problematic at best. The allegedly damning finding of the Nobel prizewinners rests on a critical assumption: “Akerlof and Shiller show how a stable equilibrium can be established, but on terms which are harmful to consumers’ interests, and beyond the power of the market to resolve.” Equilibrium economics yet again, which understates the power of the dynamic market process to disturb a stable equilibrium through discovery and innovation, in line with the CMA’s avowed view of competition. (And a retail energy market that has seen about 30 new entrants in the last few years is hardly in stable equilibrium.) The speech nicely epitomises the vision underlying the creation of the CMA. But that was yesterday’s vision, the world has moved on.
193. An ever-increasing emphasis on behavioural economics and hence customer engagement, while understandable in itself, has led to a distortion of thinking and policy on regulation and competition. There are now lessons to be learned from experience and from further economic analysis. A more balanced approach may be emerging at the political level. It remains to translate this into thinking and practice by regulatory and competition authorities. The CMA is well placed to lead this. Whether this will be reflected in the CMA final reports on *Energy* and *Retail banking* remains to be seen.

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<sup>185</sup> Alex Chisholm on consumer engagement in a digital world, speech at CCRP 2016 Competition Policy Roundtable in London, 21 January 2016.

Table 1 CC and CMA Market Investigations

Date referred	Date reported	Title	Mentions of well-functioning market in Provisional & Final Reports	Conventional (relative) interpretation?	Excess cost calculation?
	Jun-03	<i>CC3 Guidelines</i>			
18-Mar-04	07-Mar-06	Store card credit services	No	(Yes)	No
05-Jul-04	29-Jun-06	Domestic bulk liquified petroleum gas	No	(Yes)	No
20-Dec-04	30-Nov-06	Home credit	Yes 1 → 3	Yes	No
05-Apr-05	21-Dec-06	Classified directory advertising services	Yes 3 → 9	Yes	No
26-May-05	15-May-07	Personal current account banking services NI	Yes 12 → 16	Yes	No
09-May-06	30-Apr-08	Groceries	Yes 2 → 4	Yes	No
07-Feb-07	29-Jan-09	Payment protection insurance	Yes 9 → 31	Yes	No
29-Mar-07	19-Mar-09	BAA airports	Yes 11 → 13	Yes	No
26-Apr-07	07-Apr-09	Rolling stock leasing (ROSCOs)	Yes 3 → 65	No	No
07-Jan-10	20-Dec-11	Local bus services	Yes 4 → 3	Yes	No
14-Aug-10	02-Aug-12	Movies on payTV	No	(Yes)	No
	Apr-13	<i>CC3 revised Guidelines</i>			
21-Oct-11	15-Oct-13	Statutory audit services	Yes 7 → 19	Yes	No
18-Jan-12	14-Jan-14	Aggregates, cement & ready-mix concrete	Yes 8 → 26	Yes	No
04-Apr-12	02-Apr-14	Private healthcare	Yes 1 → (1)	(Yes)	No
29-Sep-12	24-Sep-14	Private motor insurance	Yes 8 → 8	No	No
27-Jun-13	24-Feb-15	Payday lending	Yes 8 → 11	Yes	No
26-Jun-14	10-Jul-15	Energy (Provisional)	Yes 17 → ?	No	Yes
06-Nov-14	22-Oct-15	Retail banking (Provisional)	Yes 8 → ?	Yes	No