Zeeman lecture

The use and abuse of the notion of effective competition: Caroll, Orwell and McCarthy revisited?"

Thank you to George and the RPI for asking me to deliver this year's Zeeman lecture. It is a great honour.

There are no slides for this lecture. Given its content I was concerned that slides might be misinterpreted or taken out of context. A copy of the full text of what I say will be available on the RPI website instead.

Some of you may be a little perplexed at the title. As I am the last to speak and am keeping you from your journey home I hope this will keep you listening and engaged as its meaning becomes clear over the course of the lecture.

Before I start and outline what I want to cover, some important declarations. Irwin Steltzer, a good friend of the Institute, has taught me that you should always declare your interests and allegiances before giving a speech.

Many of you know me, but for those who don't I work for Lloyds Banking Group as my day job and hold a non-executive position at British Gas. Given the material I am about to cover you should be aware of this as, to quote Nicolas Nasim Talib – the author of the Black Swan – I clearly have skin in the game.

I am also a Council Member at the Institute. I speak with that hat on today and that should make for a much more interesting lecture and lively debate. And I hope by the end of the lecture whether you are convinced

or not, that you will know that my views are not clouded by either of these positions I hold.

The genesis of this lecture and its contents starts nearly five years ago with another speech I gave at the RPI: “Assessing competition in retail markets: lessons from energy and banking”. You can still view it on the RPI’s website.

This was shortly after I left the energy regulator Ofgem. In this speech I started to express concern and scepticism about the established view – in banking - and emerging (and now entrenched) view in energy about the “effectiveness” of retail competition.

For any of you who were there at the time you will remember I asked the question: what does effective competition look like in energy or banking?

I answered with and blank slide and said I didn’t have the faintest idea in energy even after 9 years at Ofgem.

And with the mobile and digital revolution sweeping through banking I didn’t think anyone could possibly know and you shouldn’t believe anyone who told you they did.

I urged regulators and competition authorities to stop trying to answer an impossible question or worse still impose their own view of what the answer should be. They should focus more on economics of the competitive process by assessing barriers to entry, expansion and customer switching and where problems were identified they should try to identify proportionate remedies.

I have also covered many of the themes I will raise today in a series of other speeches and comments since then both at RPI seminars and Beesley lectures.

In particular I have been forceful and forthright in my views that if there is a problem of "lack of engagement" or so called "sticky/inert" customers and that I generally placed far more faith in the market process to find ways to engage these customers than regulators.

As evidence of this look at the creation of an entirely new, vibrant and innovative industry in comparison sites that have made it their mission to make it more and more simple and easy for customers to compare prices and switch. They have been remarkably successful in doing so and continue to innovate in this space.

The six largest get 11m visits each month and spend £110m a year in ever more entertaining or irritating – depending on your point of view – new ways to get customers to engage and shop around. Martin Lewis alone gets 3.6m views a month: he runs an energy club and several successful collective switches without any mainstream advertising.

They have also turned industries such as insurance on their head: two thirds of all car insurance is bought through them. They are seeing rapid growth in other services now accounting for nearly half of all home insurance and a third of all credit cards. They continue to grow aggressively. They have saved customers billions of pounds.

But these arguments did not appear to be getting through to regulators. So two years ago when I responded to Amelia Fletcher's Beesley lecture on Privatisation, Competition and Sector Regulation I expressed great hope that there would be an energy reference and that the CMA would

inject some sense and sanity into the debate and bring it back to sound economics.

I got my wish for an energy reference. It may also surprise some of you to learn – despite by day job- I also wanted a banking reference for broadly the same reasons. So I was doubly blessed.

When I first suggested to George giving the Zeeman lecture both inquiries had been announced. Given the timings of the inquiries and the September conference we knew that they should both be far enough advanced that there would be sufficient material. We were right.

But this is the version of the lecture that I hoped I would not have to give.

I give this lecture with a heavy heart. It is going to make for uncomfortable listening (or reading) for anyone who works for Ofgem or the CMA. I have many friends and former colleagues at both organisations so I do not do this lightly or with any relish but as a concerned and critical friend.

As someone who has worked in this field for over 20 years and as a firm believer in, to quote John Kay, the genius of markets I think the public policy issues at stake are too significant to ignore.

So on to the substance. I think we have three problems.

(1) A problem with the intellectual and analytical framework used by Ofgem, potentially other sector regulators, and the CMA when carrying out market studies and investigations. This revolves

around the ill-defined concepts of "effective competition" and the closely related but equally ill-defined concept of a "well functioning market"

(2) An institutional problem: The CMA has found that the sector regulator – Ofgem - is a big part of the energy problem. Policies and rules implemented in a series of interventions over the last seven years have restricted and distorted competition. If you have the courage to join the dots in the CMA's analysis you can only conclude that this has cost customers several billion pounds in higher prices than if they had not been in place. You can quibble over the exact amount but not the order of magnitude. It is billions.

(3) A third problem that may be intellectual/analytical or institutional with the way the CMA and regulators goes about assessing and designing remedies when carrying out market studies where it finds competition problems.

Although I will primarily use the energy and banking industries and inquiries to illustrate my concerns they have much wider applicability.

The first and third problem relate to the whole market inquiry regime. So they naturally read across to any non-regulated sector that could face a market inquiry by the CMA but could also spread like a virus to the way that other sector regulators carry out market studies.

The title of the lecture refers to the first problem.

But this then naturally leads to a need to examine the second problem

And then as I try and consider what could be done to fix these first two problems this inevitably leads to the third problem.

Do I have solutions? Yes and no. On the first I think I can offer some concrete suggestions for discussion and debate.

The second is far more difficult but is as, if not more important, than the first given what has happened in energy over the last seven years.

The third, I think, is the easiest to fix and to the CMA's credit I think they accept the problem. I chaired a session at the RPI's conference in April where Andrea Coscelli, a Board Member at the CMA, accepted the problem and offered strong support for my proposed solutions.

And there are some encouraging signs in the banking inquiry that the CMA are starting to walk the walk. But the CMA and regulators will need help and support from many in the room to embrace the solutions and to persuade the media and politicians who want inquiries to be faster and produce simple, quick solutions to complex problems to give the CMA and regulators the time and space to do this.

So let's start with the first problem.

It starts with a simple concept. If you do a quick google search on the words "effective competition" you will quickly find links to the CMA, and the sector regulators (with some obvious exceptions) all of whom claim it is their primary purpose to promote "effective" competition. For many of them it is actually one of their primary statutory duties

The CMA state in their Guidelines for market investigations that:

“Regulators, competition authorities and governments have an important role to play in making sure competition is as effective as possible.”

It goes on to state that the regime allows competition authorities “the opportunity to assess whether competition in a market is ***working effectively***”

At this point you might think – what is the problem?

Effective competition as a concept sounds much like the Hitchhiker’s Guide to the Galaxy’s description of Planet Earth – mostly harmless – doesn’t it?

No.

The problem is that there it is an ill-defined and therefore dangerous concept.

The Guidelines accept and acknowledge this by stating that there is no bright line benchmark against which the effectiveness of competition can be assessed in an investigation. It states that investigations will seek to establish “competition problems” and the “feature” causing the problem or more specifically to identify “adverse effects on competition” that may be structural or - more ominously - relate to “the conduct of customers”

So they introduce the concept of a “well functioning market” as the appropriate benchmark. This is where the problems begin.

The Guidelines helpfully state that a "well functioning market" is **not** an idealised perfectly competitive market. Austrian economists can breathe a sigh of relief at this point.

But the definition then almost becomes circular. As a "well functioning market" is simply one that does not give rise to any "adverse effects on competition"!

Here is where the title of the lecture may begin to make a little more sense. In Alice in Wonderland:

Who decides meaning and on what basis? When **I** use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean — neither more nor less.' 'The question is,' said Alice, 'whether you **can** make words mean so many different things.' 'The question is,' said Humpty Dumpty, 'which is to be master — that's all.'

This may all sound a little esoteric or theoretical at this stage so let me bring this to life by looking at how these concepts are used in practice.

In the energy inquiry Provisional Findings there are 16 references to "effective competition" and 16 references to "well-functioning market".

In fairness to the CMA several of the references to effective competition actually refer to Ofgem's statutory duties and the changes introduced by the then Secretary of State, Ed Miliband who replaced the relatively simple duty of

"protecting customers interests wherever possible by promoting effective competition" with the requirement

"to consider whether there are is any other manner (whether or not it would promote competition) in which Ofgem could carry out its functions."

At this point I am reminded of my five year old son's favourite current expression: "What does that even mean?"

It also explains the reference to Orwell in the lecture title. In Politics and the English Language he said:

"What happens to language when politicians seek to exert control over meanings – vagueness, malleability, lack of precision and uncertainty: if you are not guilty of this then you are guilty of that."

The CMA to their credit understand this and do suggest this duty is part of the problem and I agree. But for reasons I will go on to explain it is not the only problem.

The CMA also rightly conclude that many of Ofgem's actions and decisions such at the anti-discrimination clause and the simpler choices component of the RMR reforms had not had the effect of promoting effective competition.

But the CMA does make at least two ominous uses of the term:

"The CMA wants to assess how effective competition has been in meeting customers' needs"; and more dangerously

"set out our assessment of the sorts of outcome we would expect effective competition in retail markets to lead to."

Now look at the use of "well functioning market". Almost all 16 references are dangerous and impose the CMA's own subjective views of

what the CMA would expect a well functioning wholesale or retail energy market to look like.

But in the interests of time let me just highlight the more frightening uses:

"We would expect competition in a well-functioning market to be largely on price"

"Under a well functioning market in which costs and profits are competed down to efficient levels"

"In a well functioning market we would expect to see evidence that customers only stayed on these high price tariffs for transitory periods."

The banking inquiry has not yet reached provisional findings and so the CMA has yet to set out its views on what are or are not the competition problems. But you can still find, in the annotated issues statement, statements such as:

"these low switching rates may not be consistent with a well-functioning market and that more engaged customers would be expected to drive better competitive outcomes."

At this point we are, to go back to Alice, in danger of Humpty Dumpty economics. The CMA or the relevant regulator must ensure "effective competition" by comparing it to the benchmark of a "well functioning market" that they define.

Would any reference market be found to be “effectively competitive” against the “well-functioning market” benchmark? And is there any sound economic basis for some of the outcomes the CMA states it would expect to see in a competitive market?

I don’t think so.

Let’s start with a simple personal story. It probably won’t surprise you to learn that I have switched my energy supplier many, many times. Typically every year. I am an effective, well functioning consumer in that respect.

I liked my previous supplier Ovo Energy. They had a simple app that allowed me to submit meter reads each month and so I always got accurate monthly bills. They paid me 3 per cent interest if I had a credit balance on my monthly direct debit. So I was a little disappointed to find they weren’t the cheapest. So I switched to Co-Op to save £75.

They took 6 weeks to switch my account (Ovo had done this in 2) and I had a month on a more expensive Ovo tariff. The CoOp’s IT systems went into meltdown. I did not get a bill for three months. They took three months to collect a direct debit so I am now in debt to them. And they don’t have an app so I don’t submit meter readings any more or know how much I owe them.

But as the CMA reminded me – I should expect a well functioning energy retail market to be mainly about price so what did I expect for something costing £75 less a year?

And more generally: what basis is there in economic theory or history for costs and profits converging to efficient levels? There isn't. The reality of markets is that cost/profit convergence is the exception not the rule.

Will the smartphone market be deemed to be not well functioning until Apple's costs and profits converge to Samsungs? Have British Airways' short haul costs converged to Ryanair or Easyjets? Their profits certainly haven't.

Inefficient companies generally lose money and go bust. Often spectacularly with little warning. Some die slow painful deaths. Convergence is again the exception not the rule.

But this doesn't happen in energy does it? People have short memories. Those of us with longer memories remember the collapse of the fifth largest energy supplier in the UK – TXU. And the collapse of many smaller, independent suppliers with millions of customers who could not invoice and bill correctly (Independent Energy) or took aggressive decisions to buy direct from wholesale markets and not hedge.

I believe one or two banks and building societies may also have suffered the same fate.

So how do we fix this problem?

First abandon the concepts of "effective competition" or defining what a "well functioning market" looks like. Go back to the economics of the competitive process. Examine barriers to entry, expansion and switching.

If customers appear to be "inert" or "disengaged" then don't rely on qualitative surveys to tell you why or what they want or would prefer. They have now been almost completely discredited through behavioural studies and so should be given almost no evidential weight.

Look at what customers actually do and if you have a theory about why then use testing and trialling during the course of the inquiry to diagnose and test your hypotheses and assumptions.

We are pioneering this approach at Lloyds in the banking inquiry. We are running several live, randomised customer trials with both business and personal current account customers to try to understand and evidence why customers behave in certain ways and test some of the CMA's emerging hypotheses during the course of the inquiry.

For example customers who use overdrafts have long been considered poorly served by the market. It is a fact that they are less likely to switch. And customers who use unplanned overdrafts pay far more than they need to. So we are running trials to try and understand why and whether simple changes such as text messages to customers who frequently go overdrawn about how to simply cut the cost. And trials to see whether changes to the switching process so that customers get certainty their overdraft will be matched at their new bank encourage more to switch.

Institutional failure

So we now know in the wrong hands the current framework and test is ill-defined and can give rise to Humpty Dumpty competition economics.

This leads to the difficult second problem: institutional failure. The risk that a regulator could collectively lose its marbles, be captured and/or make bad decisions that harm customers and competition is not new and has been long understood. Protections have been put in place and enhanced since the concept of independent economic regulation was introduced in the UK more than 30 years ago. Appeals processes have been put in place that have been widened both in terms of the scope of decisions that can be appealed, who can appeal and the basis of appeals and whether they are subject to narrow judicial review or full merits review.

And we had the move from Director Generals to Authorities modelled on corporate boards to supposedly guard against too much power vested in one individual.

But the uncomfortable truth is that all of this failed in energy with disastrous consequences for customers and competition. And what is even more concerning is that this situation was allowed to unfold and go on for 7 years. It still is.

Now as a former regulator I am sympathetic to the idea that **to err** is human and that regulators have to make difficult judgements where the evidence is not always clear. But this was not the case in energy.

When Ofgem started down the path that seven years later has lead to the unprecedented finding of the sector regulator being the feature of the market that restricts competition they were clearly warned. By a member of their Board – who subsequently resigned over the matter. By the former Director General of Electricity Supply, the Office of Fair Trading and a leading academic energy economist.

And as the evidence emerged that prices and profits were rising as had been predicted, they carried on. Despite being in a hole, they kept digging.

And the consequences for customers, according to the CMA have been disastrous: prices and profits rose and customers have in aggregate paid billions more than they would have done if none of these measures had been implemented.

I don't lay all the blame at Ofgem's door as many of the energy suppliers who now tell the CMA this was all very bad did nothing to stop this along the way. Any supplier could have triggered a CMA inquiry many years ago simply by refusing to accept the licence conditions to implement them. But in general, turkeys don't vote for Christmas.

But we do have an institutional problem when a tragedy on this scale is allowed to go on for so long and with such significant consequences and none of the institutional safeguards – the presence of Boards with a changing cast of members, the ability of suppliers large and small to trigger appeals and the appeals regime allows this to stop.

So this was a collective failure on a grand scale over several years. The most important question is how to stop it happening again? This is a big public policy question that nobody seems to be asking or willing to tackle.

How do we stop this happening again in energy or indeed in any other regulated sector?

There are two interesting and provocative analogies. As Stephen Littlechild and George Yarrow have pointed out the combination of rules

and restrictions put in place by Ofgem over this period are equivalent in their economic effect to price fixing.

And we are all well aware of the law prohibiting price fixing and the consequences for organisations and individuals for that offence.

And closer to home, I now operate under a regime where to try and prevent this sort of problem occurring again in banking my – and other senior executives pay is now open to claw back for ten years if I am subsequently found to have exposed the bank to excessive risk and/or not taken actions to prevent this happening.

Another sanction open to regulators in financial services is to ban individuals from working in the sector for any period of time including effectively a life sentence.

Although perhaps on second thoughts a prohibition on working for a regulator for the rest of their life might be seen by some as a reward not punishment.

Now onto the third problem.

If we can get the CMA and sector regulators to apply a more rigorous approach to defining and assessing competition and if they find a problem, how do we ensure that the cure they impose is not a) ineffective or b) worse than the identified problem?

I think this is the simplest to fix and may go some way to mitigating the previous two problems.

The first is that any remedy should by default expire after two years. That does not mean that it cannot be extended. But the relevant competition authority and/or regulator should have to positively make the case and be open to challenge.

If you aren't persuaded this is necessary I would point out at this stage that as part of the current banking inquiry the CMA is carrying out a review of whether it should remove undertakings imposed on the banks in the SME banking inquiry 12 years ago.

The second is that any proposed remedy designed to deal with customers behaviour should be tested and trialled before being implemented. In the private sector there is a revolution going on accelerated by the digital revolution and the dramatic reduction in the cost of storing and analysing vast quantities of data. It is now cheap, simple and quick in general to test in a rigorous and controlled way whether behavioural remedies will have any (let alone the desired effect).

Clearly this does not work for all remedies. You cannot test and trial a divestment remedy. But it would be a start. If you are proposing a very significant intervention – like a default tariff scheme – and aren't persuaded by either the Government's own Behavioural Insight's team or general economic theory of its potential harmful/unintended effect you should work really hard to think about how you might test its effect. If necessary in well designed experiments rather than the real world before you inflict it on customers.

And now, you will be pleased to hear I am reaching the end of the lecture. I have covered a lot of ground so I wanted to conclude with a relatively short and simple summary of what I have said. And then I will finally

explain the third reference in the title to McCarthy that for those of you paying attention you will have noted I have yet to refer to.

It can be boiled down to three problems. First, don't let politicians cloud the meaning of competition in regulator's duties. Competition authorities and regulators need to go back to the economics and a) be careful when using the term "effective competition" and b) abandon the benchmark of the "well functioning market" and their own views of what this should be in any particular market. Competition is a process not an outcome. In seeking to deliver effective competition focus on the impediments to the process not whether a particular market delivers the outcomes you think it should or would like it to. Second we need to tackle the hard question of how to avoid another institutional failure on the scale of the energy market. This should never happen again. And third the CMA and regulators need to radically re-think their approach to remedies design. Energy would be a good place to start.

And that is where McCarthy comes in. Not Senator Joe who according to Wikipedea was famous for the practice of making unfair allegations – a charge that could be levelled against some of the way that market investigations assess markets. We need less of this and more of the Callum McCarthy kind who had the courage and conviction to remove retail energy price controls and understood only too well their political and economic downsides.

Thank you for listening to me and I hope that you are not all too exhausted or keen to get home and that we can have a debate.

I am happy to answer questions but would be as, if not more, interested in your views on these issues and if you agree with my diagnosis whether you have better ideas on how we might solve them.