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energy sector: some concerns about the proposed
interpretation

Stephen Littlechild

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1. Introduction

Ofgem, OFT and CMA are presently carrying out “an assessment of how well competition in the markets for gas and electricity is serving the interests of households and small firms in Great Britain”. They intend to publish a first assessment by the end of March 2014. The outcome of Ofgem’s consumer research will follow in late spring. Ofgem, OFT and CMA will then each consider their next steps. All options remain open, including a market investigation reference.

The three organisations have jointly set out a competition assessment framework.² It is said to follow a standard typology, based on Competition Commission (CC) *Guidelines*.

3.2 The framework consists of three stages:

A description of a well-functioning market, and how competition should work to deliver desired outcomes;

An explanation of the broad categories of reasons why the competitive process may not be working as it should (potential ‘sources of harm’); and

An explanation of how we will use data and information (‘indicators’) to identify features of the market and analyse, investigate and conclude on how these features affect the process of competition and outcomes for consumers, including vulnerable consumers.

The concepts of “a well-functioning market”, “sources of harm” and “indicators” are relatively new in the context of energy markets. The purpose of the present paper is to examine how the CC *Guidelines* and market investigations introduce these concepts, and how the framework proposes to interpret them. The paper identifies some concerns about these proposed interpretations. Since the framework is a joint project with OFT and CMA, the concerns apply not only if the competition assessment is an annual report by Ofgem but also – and perhaps especially - if it is the basis for a formal market investigation by CMA.

¹ Emeritus Professor, University of Birmingham, and Fellow, Judge Business School, University of Cambridge. I have benefitted from discussions with colleagues including Eileen Marshall, Steve Smith, Catherine Waddams and George Yarrow, but none of these is responsible for what is written herein.

² Ofgem, OFT and CMA, *State of the market report – Assessment framework*, 19 December 2013.

2. The well-functioning market in the CC Guidelines

The concept of a well-functioning market was not mentioned in the CC's 2003 *Guidelines*³. It seems to have been first used by the CC in a couple of market investigation reports published in 2006. It is mentioned, but generally briefly, in most but not all subsequent reports. It is formally discussed in the CC's 2013 *Guidelines*⁴. There, it is defined in the context of an adverse effect on competition (AEC). The first relevant paragraph reads

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.

Later, the *Guidelines* say

320. In identifying some features or combination of features of the market that may give rise to an AEC, the CC has to find a benchmark against which to determine how the market may be judged to be performing. In the absence of a statutory benchmark, the CC defines such a benchmark as 'a well-functioning market' (see paragraph 30) —ie one that displays the beneficial aspects of competition as set out in paragraphs 10 to 12 but not an idealized perfectly competitive market.⁵ The benchmark will generally be the market envisioned without the features. But there may sometimes be reasons to depart from that general concept ...

Already there are three problems. First, the wording “uses” and “defines” suggests that this is something the CC always does. This is not the case. The term well-functioning market was not used in the first two market investigations, nor in a recent case that reported before the revised *Guidelines* were published (Movies on Pay TV, Report 2 August 2012). Nor is it mentioned in a subsequent case (Private Health Services, Provisional Findings 2 September 2013).

Second, the two paragraphs give two slightly different definitions: in para 30 it is “a market without the features causing the AEC” whereas in para 320 it is “one that displays the *beneficial* aspects of competition as set out in paragraphs 10 to 12” (italics added). The latter are the three paragraphs beginning “10. Competition is a process of rivalry as firms seek to win customers’ business.” Whether a market without the AEC necessarily exhibits all and only the characteristics described in paragraphs 10 to 12 is an intriguing question. But does the second definition mean that competition has only beneficial aspects? Or that only its beneficial aspects are to be considered as part of the well-functioning market? If competition tends to drive prices towards costs, so that prices fall for customers that are lower cost to serve and rise for customers

³ CC3, *Market Investigation References: Competition Commission Guidelines*, June 2003.

⁴ CC3 Revised, *Guidelines for Market Investigations: Their role, procedures, assessment and remedies*, April 2013.

⁵ CC footnote: *See, for example, the CC report on the PPI market investigation. Referring to this in its judgment in Barclays Bank v CC (October 2009) the CAT wrote (paragraph 104): On a fair reading, the Commission concluded that a well-functioning market for PPI (ie a market without the AEC) was consistent with the continuation of some incumbency or POSA being enjoyed by distributors and intermediaries. There is, in our view, a clear distinction between a properly functioning market unaffected by an AEC and an ideal market, in which every potential supplier of the relevant product competes on a precisely level playing field.*

that are higher cost to serve, does that mean that the latter tendency is inconsistent with a well-functioning market?

Third, it seems clear that a well-functioning market is not an idealised perfectly competitive market. It is the market without the features that give rise to the AEC ... except when it isn't. So we have to look more closely at the CC's 14 market investigation reports to date to discover how the term is actually used in practice.

3. The well-functioning market in CC market investigation reports

It turns out that, even where term "well-functioning" appears, in most cases the CC market investigations use it in a perfunctory way. The benchmark is indeed often said to be the market without the features giving rise to the AEC. But mostly the reports find little or no need to use the term: generally it appears only about two or three times - not more than half a dozen times - in reports that are hundreds of pages long. More common wordings are "prices are higher than would be the case if these features did not exist" or "prices are higher than would be expected in a competitive market", or simply "relatively high levels of prices".

In those few cases where the CC group put special emphasis on the term, it got into difficulties. Thus in Store Cards (Report 30 November 2006) it explained that "Even in some reasonably well-functioning markets, some prices will exceed efficient costs, often by quite a large margin and for some time." (7.38) But the report was unable to pin down further what prices would be like. One is left with the impression "we are not sure what prices would obtain in a well-functioning market, but we are confident that they would be materially less than the ones that we have observed".

The ROSCOs case (Report 7 April 2009) provided the most explicit justification for constructing a well-functioning market.

8.4 ... 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.

As usual, the report explained that the well-functioning market was "not necessarily one where there is perfect competition" – implying that in principle it just *might* be one where there is perfect competition – then elaborated that it was

a market where competition is as effective as possible having regard to the nature of the product and the circumstances in which it is supplied. It is a hypothetical comparator and is not necessarily a market that could be created in practice.

The last phrase could have been expected to be problematic, and was. What is a market "where competition is as effective as possible", but "not necessarily a market that could be created in practice"? The group "used our judgement to decide to what extent the well-functioning market in this case should reflect aspects of the actual market." (para 4.28) It set out its assumptions

over several paragraphs, concluding that “This process of competition would result in a market equilibrium ...” (para 4.30)

The group then ran into difficulty. One member disagreed with the majority’s characterisation of the well-functioning market, and argued that it should include a market for used as well as new rolling stock. On this basis he argued for an additional cost-based price cap that the majority rejected. The rather surreal nature of both conceptions of the well-functioning market was reflected in the acknowledgement that

in practice there is no possibility of entry or expansion in the market for used stock in Great Britain. ... However as our report states, the well-functioning market is a hypothetical comparator, one where competition would be deemed to be working effectively if circumstances were different, and it is not a necessary requirement in identifying this comparator that changing those circumstances should be practicable. (Dissenting opinion para 4).

There is another difficulty with the group’s definition. There are surely two main reasons why the CC has explicitly not taken a well-functioning market to be in perfect competition. The first is that the assumptions of perfect competition – homogeneous product, many buyers and sellers, perfect information etc – are too restrictive. In practice, in many markets less restrictive assumptions are “good enough” to get the benefits of competition.

The second reason for rejecting perfect competition is that it assumes a market in equilibrium whereas the CC knows full well that real markets are always in a state of change. A well-functioning market in equilibrium is therefore one that, by definition, does *not* display the “beneficial aspects of competition set out in paragraphs 10 to 12” of the *Guidelines*. Consider the opening description given there.

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 (emphasis added).

The *Guidelines* explicitly depict competition as a process of rivalry taking place over time (a depiction that is even more explicit in the 2003 *Guidelines* paras 1.16-1.18). As the underlined words indicate, the CC *Guidelines* see competition as a process of *change*, explicitly *not* as a state of equilibrium.⁶

⁶ Key contributions to the concept of competition as a rivalrous process over time include J A Schumpeter, *Capitalism, Socialism and Democracy*, Harper & Row, New York 1942 3rd ed 1950 especially chapter VII The process of creative destruction; F A Hayek, “The use of knowledge in society”, *American Economic Review*, September 1945, reprinted in Hayek, *Individualism and Economic Order*, London: Routledge and Kegan Paul, 1948; F A Hayek, “Competition as a discovery procedure” in Hayek, *New Studies in Philosophy, Politics, Economics and the History of Ideas*, Chicago: University of Chicago Press, 1978; I M Kirzner, *Competition and Entrepreneurship*, Chicago: Chicago University Press, 1973; I M Kirzner, “The Perils of Regulation: A Market Process Approach” in Kirzner, *Discovery and the Capitalist Process*, Chicago: Chicago University Press, 1985; I M Kirzner, “Entrepreneurial discovery and the competitive market process: an Austrian approach”, *Journal of Economic Literature*, March 1997. A recent and accessible succinct exposition is in I M Kirzner, *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, Institute of Economic Affairs, Hobart Paper No 133, June 1997, available at www.iea.org.uk

Finally and most recently, in Audit Services (Report 15 October 2013), the group defined the well-functioning market as the market without the features causing the AEC. Indeed, “we do not consider there to be a realistic alternative comparator for the relevant market”. (para 7.1) But one party asked how the group could define a market without the features causing an AEC if those features were intrinsic to the market – in this case “audit is in part an experience good, the scope of which changes after appointment”, so how could the group also identify that very feature as an AEC?

In contrast, an earlier case had no difficulty in dealing with an intrinsic feature of the market, and it is probably relevant that a well-functioning market was not invoked. BAA Airports (Report 19 March 2009) “concluded that Aberdeen had the characteristics of a natural monopoly, deriving from its comparatively isolated geographical location”. (para 10.198) It then found that “Aberdeen’s local market power was reflected in relatively high levels of prices and profitability and relatively low levels of investment.” (para 10.200) It would be difficult to find a more intrinsic feature of a market than an airport’s geographical location. But the group were able succinctly to identify, assess and remedy the consequences of this feature without reference to the concept of a well-functioning market. The *Guidelines* subsequently cited this approach as an example of non-price indicators.⁷

Thus, the concept of a “well-functioning market” is both unnecessary and has proved problematic in practice. Having made the point that the benchmark is not an idealised perfectly competitive market, a CC market investigation reference could simply replace the term “well-functioning market” by a phrase such as “competitive market” or “market without the features giving rise to the AEC”. That would be simpler and would not raise problematic questions about what the hypothetical well-functioning market really is.

4. The well-functioning market in the competition assessment framework

The framework notes that, following the assessment at the end of March 2014, Ofgem, OFT and CMA will separately consider next steps. These include proposing a market investigation reference. Suppose the retail energy market were indeed referred for a market investigation. What would be the appropriate benchmark against which to assess an AEC? And what if any role would or should the well-functioning market play?

I have argued above that the concept of a well-functioning market is both unnecessary and problematic in practice. The CC’s actual practice shows that it does not have to be used. It would be entirely possible to examine the retail energy market and make comparisons against “a competitive market” or against the retail energy market in the absence of any identified

⁷ In its investigation into BAA airports, the CC compared Aberdeen Airport with other regional airports and found slower development of routes; lack of ambition in development; underinvestment and poor facilities. (*Guidelines* para 129)

AEC, or simply to observe that prices or profits or any other indicator are relatively high or low, compared for example to previous or other markets or markets in other countries. One previous CC report invoked the concept of a well-functioning market because it was not obvious what a competitive market would look like. That is not a relevant consideration here: the GB retail energy market has been open and competitive for over a decade. Thus, there seems no case for the CC to define its own counterfactual well-functioning retail energy market, and every reason to take a simpler, less problematic approach.

However, this is not how the present competition assessment framework sees the situation. It makes no mention of the s 30 definition (the market without the features causing the AEC). It goes straight to the s 320 definition, invoking the beneficial aspects of competition, and seizes the opportunity to insert its own priorities.

3.4. The framework, like other competition assessments, uses the concept of a hypothetical well-functioning energy market. This well-functioning market acts as a comparator against which we can assess the effects on competition of identified features of the market. It is not an idealised or perfectly competitive market, but one that allows the benefits of competition to occur. 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 (emphasis added)

The framework next cites the beneficial aspects of competition set out in para 10 of the CC's *Guidelines*, then launches into a more detailed "look at some of the characteristics we would expect to see in a well-functioning energy market in the short and longer term" (para 3.6):

3.8. In the short term, we consider that a well-functioning energy market would be characterised by consumers being engaged and empowered to secure good outcomes when they participate in the market. For example, they should receive good service and clear, understandable communications. We would also expect to see pressure on suppliers' costs and margins.

...

3.10. In the longer term, we would expect the outcomes described in the section above to persist. In addition, a well-functioning market would be characterised by further changes in suppliers' behaviour, leading to a more dynamic, innovative market. In such a market we would expect to see suppliers and new entrants (some using new commercial models) reacting to changes in the market to offer consumers new products and services.

Thus, the competition assessment framework has rejected the approach to the well-functioning market that has been adopted in almost all of the CC market investigations to date. Instead of defining a well-functioning market grounded in the actual market, the framework has adopted the do-it-yourself approach used in the three exceptional CC market investigations. One of these left the definition of the well-functioning market obscure, one led to a subjective and disputed reconstruction of what might constitute a well-functioning market, with a split in the group as to remedies, and one was criticised for the use of mutually-inconsistent assumptions.

Opening the investigation to a subjective definition of a well-functioning market is tantamount to opening Pandora's Box. Since OFT and CMA are not yet expert in retail energy markets, the background to the framework description is presumably "Ofgem's vision" described in the Executive Summary to the document.

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.

This is looking less like a description of how a competitive retail energy market would actually operate. It is, literally, a “vision” of a competitive market, that would exhibit “new entrants ... innovative products ... high levels of customer service, significant switching” etc. The vision is not anchored in any concept of what levels of new entry, innovation, customer service and switching it is realistic to expect a competitive market to provide. Obvious comparators are the UK retail energy market in previous years, energy markets in other countries with and without retail competition, markets for other utility products, and markets for other products and services generally. None of these real markets is mentioned: the benchmark is simply a vision.

Like the opening reference in the framework, to “how competition should work to deliver desired outcomes” (para 3.2), this is an instrumentalist view of competition. It is not based on an understanding of how markets actually work. It is a description of how a regulatory body, subject to statutory duties and political pressures, would find it convenient for a competitive market to work, in order to “deliver desired outcomes”.

5. Indicators of a well-functioning energy market

As noted earlier, the framework proposes to “use data and information (‘indicators’) to identify features of the market”. I focus here on one aspect of this. The *CC Guidelines* refer to “incentives for firms to meet the ... needs of customers ... by improving quality or variety, or introducing new and better products”. (para 10). In discussing non-price indicators it says:

127. ... Poor quality, lack of innovation, or limited product ranges are prominent among other indicators of weak competition in a market.

128. ... In its investigation into PPI, the CC considered evidence it had obtained so as ‘to identify: any new PPI policies which had been introduced, whether there had been any innovations within existing policies, the rationale for product change or innovation, and whether, and if so how, distributors advertised and marketed their policies’.

One would therefore expect to see, inter alia, indicators seeking to measure the extent to which the market had been characterised by innovation and increasing product ranges, the introduction of different services or discounts geared to the needs and situations of different types of customers, and so on.

This is in fact what Ofgem found when it reviewed gas and electricity competition back in 2001.⁸

6.1 The existence of a range of offers would tend to suggest that customers are able to benefit from the operation of the competitive market. Competitive pressures, responsiveness to demand, and innovation may also be indicated by the existence and range of non-price offers.

...

6.17 The range of tariffs and offers available to customers has continued to widen and become more innovative. Certain offers have been in existence for several years, such as green tariffs, energy efficiency deals, offers targeted at disadvantaged customers, complementary products such as dual fuel tariffs, affinity deals and online services. Such established offers have been taken up by more suppliers and have become more responsive to customer demands.

6.18 In addition to these developments new innovations have emerged including loyalty cards, offers aimed at students, and no standing charge offers in electricity supply. Also some switchers who have not made a saving since switching can benefit from double the difference offers. Some of these recent developments are discussed in more detail below.....

Surprisingly, the framework document does not mention these characteristics. The Sector Overview chapter therein concentrates instead on the things that Ofgem has found wrong with the market since 2008. The framework sets out the proposed characteristics of a successful energy market, and the associated suggested indicators to assess the functioning of the market in these respects (paras 3.9, 3.13, Figs 2,3). They include heavy emphasis on high customer engagement, good service and clear communications, reflecting Ofgem's recent policy concerns. Innovative tariffs are mentioned as an indicator of a well-functioning market in the longer term. But there is no mention under longer term or short term outcomes of indicators such as the range of products and special offers.

Why is this, and why is Ofgem's approach now so different from what it used to be? Perhaps because the beneficial aspects of competition – such as the many discounts for direct debit, prompt payment, online accounts, dual fuel etc - are now at best taken for granted. At worst they are regarded as harmful complexities that serve mainly to befuddle customers and discourage them from engaging in the market. The aim of Ofgem's policy has therefore changed. Its recent aim – and the effect of its policy - has been to suppress tariff variety and to prevent firms from tailoring their products to the different needs of different customers. Such features are no longer to be identified as potential beneficial aspects of the competitive market process.

⁸ Ofgem, *Review of domestic gas and electricity competition and supply price regulation: Evidence and Initial Proposals*, November 2001.

6. Theories of harm: Hamlet without the Prince

The *Guidelines* introduce the concept of “theories of harm”.

163. To provide focus and structure to its assessment of the way competition is working in a market the CC sets out one or more ‘theories of harm’. A theory of harm is a hypothesis of how harmful competitive effects might arise in a market and adversely affect customers.

The *Guidelines* identify (para 170) five main sources of harm: unilateral market power (including market concentration), barriers to entry and expansion, coordinated conduct, vertical relationships, and weak customer response.

A market investigation of the retail energy sector would no doubt wish to consider all these. I do not discuss further unilateral market power and concentration, barriers to entry and expansion, and vertical relationships. I comment briefly below on co-ordinated conduct and weak customer response. But an even more important source of harm is noticeable by its absence from the framework.

The *Guidelines* do not list regulation or regulatory requirements as potential main sources of harm. However, the *Guidelines* are clear that “Individual theories of harm are numerous and specific to different market investigations. ...The list is not exhaustive. While the majority of theories of harm flow from these five sources, other theories may be identified that do not do so.” (paras 170, 171) The *Guidelines* say explicitly that regulatory requirements are structural features that may constitute a potential source of harm, and indeed have been found as such in previous market investigations.⁹ There is a whole sub-section (paras 223-6) on regulatory barriers to entry.

In deliberating whether to introduce its non-discrimination condition SLC 25A in 2009, Ofgem itself explicitly recognised the real possibility that this could adversely affect competition.¹⁰ There is now increasing evidence that Ofgem’s regulatory policy, via its implementation of SLC 25A, has indeed severely restricted and distorted competition in the retail energy sector.¹¹ Several indicators of competition, such as customer switching rates and variety of products, have shown a downturn since the implementation of these policies, and there is no obvious other explanatory factor. Since then, Ofgem (supported by DECC) has implemented its radical

⁹ *Specific structural features identified in past investigations to be harming competition include aspects of the planning system, government policy and the regulatory system (in the BAA airports investigation and, with regard to the planning regime, in the grocery retailing market); the criteria applied for the award of franchises (in the ROSCOs market investigation). (Guidelines para 157)*

¹⁰ “5.70 We recognise that there are risks to the intensity of competitive activity between suppliers as a result of this measure. The impact on competition is ambiguous and made particularly uncertain by the specific characteristics of the energy supply market. ... We recognise that some forms of price discrimination have in the past helped competition to develop in the domestic energy supply market.” Ofgem, *Addressing Undue Discrimination – final impact assessment*, ref 73/09, 26 June 2009.

¹¹ M Hviid and C Waddams Price, “Non-discrimination clauses in the retail energy sector”, *Economic Journal*, 122 (562), 236-252, 2012. Stephen Littlechild, Ofgem’s Retail Choice, A response to Ofgem’s consultation on SLC 25A, 28 May 2012. Catherine Waddams Price and Minyan Zhu, “Prices and consumer switching in the British retail electricity market”, Centre for Competition Policy, Working Paper 13-12, 2013.

tariff simplification policy in 2013/4, which has had a direct rather than indirect adverse effect on competition - amongst other things restricting each supplier to at most four different tariffs.¹² It is therefore surprising and disconcerting to find that the competition assessment framework makes almost no reference to regulatory policy as a possible source of harm giving rise to an AEC.¹³ This is Hamlet without the Prince.

The benchmark against which regulation as a source of harm could be measured is straightforward, and would require no sophisticated definition of a well-functioning market. The effect of SLC 25A could be assessed against the actual market until the actual market as it developed until 2008, and the effect of the tariff simplification could be assessed against the actual market as it developed until 2013.

7. Theories of harm: coordinated conduct

The framework says that “Our five potential sources of harm are based on those set out in the CC’s standard guidelines for market investigations” (para 4.1). Yet the framework omits “coordinated conduct” as a potential source of harm. Instead it substitutes “weak competition between suppliers”.

Now it is true that the framework then mentions co-ordinated conduct as a possible source of weak competition between suppliers. But why change the basis proposed by the CC? Perhaps because the policies introduced by Ofgem are a clear example of the conditions conducive to co-ordinated conduct as set out in the *Guidelines*? For example, the *Guidelines* say

252 (b) Simple and relatively undifferentiated products are more easily subject to the coordinated setting of prices than situations in which each firm’s offering is different from the offerings of its rivals.

...

259. Less obvious means and practices may also increase the transparency or predictability of the environment in which firms operate. These may include the adoption of rules of conduct, ethics codes, product standardization, regulatory disclosures, ...price computation manuals. Such practices may sometimes be justifiable on efficiency or customer-benefit grounds, but they could also create market conditions favourable for coordination.

Ofgem’s tariff simplification policy has focused on limiting differentiation of products and imposing rules of conduct, product standardisation, price computation metrics and so on. Indeed, Ofgem’s policies have addressed all the major challenges facing a group of energy retailers that might wish to coordinate their activities to reduce competitive pressure.¹⁴

¹² See Stephen Littlechild, Protecting customers or suppliers? A response to Ofgem's consultation on its Retail Market Review – Updated domestic proposals, 21 December 2012.

¹³ “the impact of regulation” is mentioned without discussion in para 4.11 as one of half a dozen aspects that the assessment will investigate in order to assess weak competition between suppliers.

¹⁴ Stephen Littlechild, Protecting customers or suppliers? A response to Ofgem's consultation on its Retail Market Review – Updated domestic proposals, 21 December 2012, especially Appendix 1 on coordinated effects. Stephen Littlechild, Simple tariffs or simply anti-competitive? Ofgem's Retail Market Review and associated developments, Beesley Lecture, London, 17 October 2013.

8. Weak customer response as a theory of harm

The fifth potential source of harm listed by the *Guidelines* is “weak customer response”. The discussion of this topic is much more extensive than in the 2003 *Guidelines*. The 2013 *Guidelines* have no less than five pages outlining all the ways in which weak customer response might manifest itself. At its most succinct, the message of the *Guidelines* is:

ways in which competition might be threatened include: ... customers may lack information about what product to choose, may not be able to judge between different products on offer (para 15).

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. (para 296)

The *Guidelines* explore ways in which weak customer response presents barriers to accessing information, identifying best value offers and switching suppliers. This includes discussion of “behavioural bias”.

The Introduction to the *Guidelines* says that “Since the inception of the regime the CC has learnt much from its practical experience of conducting cases, and has progressively refined its policies, practices and procedures. These *Guidelines* distil the lessons the CC has absorbed ...” (para 1). Unfortunately, only the last paragraph of the five pages on weak customer response gives references to how the CC has actually dealt with this phenomenon, and even that paragraph is limited to how the CC has identified causes of switching costs.

The *Guidelines* tend to see engaged consumers as a prerequisite for a well-functioning market, so that effective competition is only possible once consumers are engaged. This is an unduly restricted view of competition. Rather, competition should be seen as including the process for getting consumers engaged in the market. Because it neglects this latter aspect, the *Guidelines* are in danger of interpreting firms’ actions in a one-sided way, as tactics that simply increase complexity and discourage engagement. This may overlook that the aim and effect of these actions may well be to attract customers by increasing engagement.

To illustrate this argument, consider by analogy the impact of transport and switching costs. Any sensible concept of competition does not require that transport and switching costs be zero: that is not necessarily realistic in all or indeed any markets. It would reflect what the *Guidelines* rightly dismiss as “an idealized, perfectly competitive market”.

Rather, in assessing the nature of competition in any actual market, one might ask two sets of questions. First, is the competitive process effective given the extent of such costs - for example, does it tend to identify and reduce price differentials that exceed transport and switching costs? Second, does the competitive process seek and find ways of reducing those very transport and switching costs?

Similarly, competition does not require that all or most customers be fully engaged: to the extent that “behavioural bias” is intrinsic in human nature, it may not even be possible. Again, full engagement would be true only in an idealized market. Rather, in assessing competition in any actual market, one might pose the analogous two sets of questions. First, is the competitive process effective despite the limited engagement and behavioural biases of customers? Second, does the competitive process seek and find ways of stimulating customer engagement and overcoming behavioural bias?

From this broader perspective on competition, tactics that might be criticised from a narrower perspective have additional merit. Consider for example a remark about advertising in the 2003 *Guidelines*.

3.53 Advertising is often an important source of information for consumers, but can have an ambiguous effect on information asymmetries. Advertising and promotional offers increase the visibility of a product and provide information on price, where it can be bought and so on. However advertising may not necessarily be informative in terms of what consumers want to know about a product; rather it may contain only what firms feel consumers need to know in order to persuade more of them to buy the product.

For present purposes, the telling point is the final phrase. It is not enough to have a good product at a good price: in order to compete effectively, firms have to persuade customers to buy the product, they have to persuade customers to engage.¹⁵

Just as firms have to compete by finding ways to reduce transport and switching costs, so they have to compete by finding ways to stimulate customers to “access information ... assess these offers ... and act on this assessment”. Thus, engaged customers are not a pre-requisite for effective competition, they are a consequence of it.

9. Behavioural economics and the nature of competition

This is not to say that, if some customers are not engaged, the market is not characterised by effective competition. Competition is a process taking place over time, as the 2003 *Guidelines* emphasised. At any point in time this process will be characterised by learning and change, not by full knowledge and equilibrium. At any point in time some customers will be aware of, and will respond to, the best offers available, and some won't. But this is not a final resting place characterising the market forever after, it simply represents a challenge that competitors have not yet overcome.

¹⁵ *Clearly there is a role for advertising beyond 'providing information in response to consumer demand'. There is, in addition, a role for advertising to grab the attention of potential consumers and direct them both to the information and to the goods that are available. ... [I]n a world of complexity, change and uncertainty, it is inevitable that consumers are imperfectly aware of the qualities and promise of the multitudes of goods. The need to alert consumers to what they do not know that they do not know, is very real. ... From the mainstream perspective, advertising makes sense only as a weapon in the arsenal of the monopolist. From the perspective on advertising described here, however, advertising is plainly a tool with which to compete. ... The producer who judges more correctly what kind of dramatic advertising message will best awaken consumer interest has the more successfully served those consumers.* Israel M Kirzner, *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, IEA Hobart Paper No 133, 1997, p 55, available at www.iea.org.uk.

This brings us to what seems to be a systematic weakness that seems to underlie much of the behavioural economics literature. It fails to appreciate, or at least acknowledge, the difference between competition as a state of equilibrium and as a continuing rivalrous process over time. (To be more precise, the suggested weakness is not in the psychological and empirical literature on how customers actually do behave, but in the economic literature conjecturing on the market implications of such findings.) An implication of this lack of appreciation is that much of the behavioural economics literature, and the emphasis placed on it in the *Guidelines*, is inconsistent with the nature of competition that is emphasised by the CC.

For example, the *Guidelines* cites the literature review carried out for the OFT.¹⁶ This comprehensive and valuable survey comes to rather dismal conclusions.

6.2 The most striking result of the literature so far is that increasing competition through fostering entry of more firms may not on its own always improve outcomes for consumers. Indeed competition may not help when there are at least some consumers who do not search properly or have difficulties judging quality and prices (see Figure 4.1 and paragraphs 4.2 to 4.8). In the presence of such consumers it is no longer clear that firms necessarily have an incentive to compete by offering better deals. Rather, they can focus on exploiting biased consumers who are very likely to purchase from them regardless of price and quality. These effects can be made worse through firms' deliberate attempts to make price comparisons and search harder (through complex pricing, shrouding, etc) and obscure product quality. The incentives to engage in such activities become more intense when there are more competitors.

...

6.5 We also find that firms may sometimes have little incentive to educate consumers. This is particularly severe if educated or sophisticated consumers benefit from the pricing offered by those firms who do not engage in consumer education (see for example paragraph 3.59 and the search models). However, where learning will eventually eradicate consumer biases, firms may have a clear incentive to establish a reputation for 'fair behaviour' early on (see for example paragraph 3.111).

The analyses, results and policy implications underlying these conclusions depend critically on the assumed nature of competition. In the models summarised by the survey, sophisticated customers engage and derive the benefits of a competitive market, unsophisticated customers do not. Competitors have an incentive to try to engage the unsophisticated customers, but some customers remain unengaged and will be exploited.

However, this result is a characterisation of a market in equilibrium, when every participant has learned what it is possible for that participant to learn. By assumption, competition can do no more for the unengaged and exploited customers. In contrast, a market conceived as a rivalrous process over time would see these same customers as a challenge for competitors (including switching sites). From this perspective, the essence of competition is the search for new ways to overcome what others see as an obstacle or as impossible – in this case, to find a way of alerting the unengaged customers to a better offer. That discovery process is never-ending. The very nature of competition as a process is to disrupt a market in equilibrium.

¹⁶ *Consumer behavioural biases in competition – A survey*, A Report by Stefan Huck, Jidong Zhou and London Economics Charlotte Duke, OFT 1324, Office of Fair Trading, May 2011. For other surveys, see *What does behavioural economics mean for competition policy?* OFT, 2010 and *What can behavioural economics say about GB energy consumers?* Ofgem, 21 March 2011.

This point is in fact recognised (just) by what the survey calls “a modern classic” in the behavioural economics literature.¹⁷ The paper argues that, with unaware consumers, firms will charge high add-on fees and shroud (hide) rather than advertise their level. According to the survey

3.51 The main result of the paper is that, if there are sufficiently many unaware consumers, firms will ... systematically exploit the unawareness

3.52 In this scenario biased [unaware] consumers cross-subsidise sophisticated consumers This result is robust to even very intense competition.

However, the authors acknowledge that

Our analysis raises the question of long-run dynamics. If consumers learn to avoid add-on fees, does shrouding eventually vanish along with high add-on prices? ... We believe that fees for specific add-ons have a life cycle. When the add-on is new, it tends to be shrouded and priced above marginal cost. Over time, shrouding decreases, and the add-on price falls. Using our notation, the fraction α of myopes decreases over time, and shrouding eventually disappears. (pp 522-3)

That disruption is just a matter of time, and incentives. At any point in time, some customers may not be engaged. As in conventional economics, the greater the profit from an existing supplier serving an unengaged customer, the greater is the incentive for a rival to discover a way to engage that customer. Similarly, the greater the saving to be made, the greater is the likelihood that the customer will discover it. In behavioural economics as in conventional economics, profit is not only an indication of a problem, it is also an inherent part of the solution.

10. Weak customer response in the framework document

The framework, like the *Guidelines*, identifies weak customer response as a potential harm, and explores how it might manifest itself in the energy market.

4.19 Features of the market may mean that it is unnecessarily difficult for many consumer to engage effectively in the market. Ofgem’s RMR found that these features may include:

- A large number of tariffs, many of which have complex structures and discount arrangements. This makes the prospect of engaging in the market unattractive for many consumers and means it is often difficult for consumers who do engage to choose the best tariff for their circumstances. ...

4.20 This in combination with other market features ...could limit the ability of customers to find a better tariff and, in turn, limit the competitive pressure on other suppliers....

From the perspective just discussed, Ofgem’s RMR has been problematic. It has downplayed the extent to which retail competition has actually been effective, in contrast to Ofgem’s stance

¹⁷ Gabaix, X., and D. Laibson, “Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets,” *Quarterly Journal of Economics*, 121(2), 2006, 505-540.

up until 2008. And the framework, like Ofgem's policy, fails to acknowledge that many of the practices that it condemns and prohibits as harmful to competition may also be seen - and in my view better seen - as pro-competitive tactics seeking to stimulate customer engagement and overcome behavioural bias.

Take for example the concerns just cited in 4.19 and 4.20 of the framework. A large number of sometimes complex tariffs is said to make it difficult for customers to engage. But many of these complex structures and discount arrangements are designed to meet the needs of, and attract the attention of, particular groups of customers. They are attempts to stimulate rather than depress engagement by these customers. Accumulating empirical evidence suggests that customers are more likely to engage as a result of attractive offers than as a result of less complex ones.¹⁸ Thus, by prohibiting the arrangements proposed by firms, and imposing its own more limiting arrangements, Ofgem is actually preventing suppliers from making offers that will attract the attention of customers. It is thereby restricting rather than promoting customer engagement and effective competition.

Not only sector regulators and competition authorities are concerned about weak customer response: firms and switching sites competing in the market are concerned too. All these market participants face essentially the same challenge: to interest customers in their product and assist them to overcome the barriers to switching. Competition is a rivalrous process for identifying those market participants that can not only design the best products, but can also find the best ways to attract customers' attention and to persuade them of the merits of these products to the extent that customers actually go out and buy them. In this way, Adam Smith's invisible hand of competition not only protects customers that are well-informed and engaged. It also reaches out and draws in, to the extent that competing market participants can best devise, those customers that would otherwise be less informed, less interested and less engaged.

All this has implications for the assessment of an AEC and for the benchmark definition of a well-functioning market. Weak customer response, and limited customer engagement, no doubt influence the nature of competition. But there is limited usefulness, at best, in identifying them as an AEC. A benchmark of a well-functioning market that wishfully assumes a level of response and customer engagement that is arbitrarily higher and more satisfactory than the present level is irrelevant and misleading if there is no way to achieve that higher level of engagement (or not without compromising competition in other respects).

In an uncertain world where relatively little is yet known about customer preferences and biases, the more relevant question is how best to discover how, and how far, customers can be motivated to engage. This in turn raises the question whether regulators and competition authorities looking from afar are better placed to discover and implement answers to this question than market participants and switching sites that actually have skin in the game.

¹⁸ Miguel Flores and Catherine Waddams Price, *Consumer behaviour in the British retail electricity market*, CCP Working Paper 13-10, October 2013.

11. Ofgem, OFT and CMA – whose framework is it anyway?

The assessment of competition in the retail energy market, due for publication by the end of March 2014, is said to be conducted within a framework based upon *CC Guidelines*. This paper has examined some key features of those *Guidelines* - the nature of the well-functioning market, the indicators of competition and the theories of harm including the concept of weak customer response - and how the framework proposes to apply this in the case of the retail energy market.

I have suggested that the *CC Guidelines* have certain limitations with respect to the concept and definition of a well-functioning market and the concept of weak customer response as a major source of harm. The well-functioning market is neither necessary nor helpful. Weak customer response is given undue prominence and does not sit well with the CC's commitment to competition as a rivalrous process taking place over time. The CMA may wish to consider these matters as it embarks on its new life.

More urgent is the framework for assessing competition in the retail energy sector. The framework document exploits the limitations just mentioned. Not surprisingly, perhaps, it is presented from an Ofgem perspective. This perspective is reflected in

- the definition of a well-functioning market as one embodying Ofgem's instrumentalist vision of competition to "deliver desired outcomes";
- the absence of range of tariffs and discounts as indicators of competition, both of which indicators Ofgem's policy has explicitly hampered;
- the lack of focus on regulatory policy as a possible source of harm, despite explicit mention in the *Guidelines* of this as a possible source of harm and despite considerable accumulated empirical evidence that Ofgem's policy has in fact restricted and distorted competition;
- the substitution of weak supplier response for coordinated conduct as a potential source of harm, when Ofgem's policy has required firms to adopt policies that the *Guidelines* suggest can be expected to facilitate coordinated conduct;
- the characterisation, in line with Ofgem's policy, of tariffs with complex structures and discount arrangements as simply a potential harm to competition that prevents customers from engaging in the market, when such tariffs are also a means of competing by offering benefits to customers and thereby encouraging them to engage.

This approach and presentation would be understandable if the framework were an Ofgem document, describing an Ofgem-only project. One might disagree with the perspective, but one could hope and expect that OFT and CMA would take a different and independent perspective.

However, the framework is not solely an Ofgem document: it is a joint statement by Ofgem, OFT and CMA. This means that OFT and CMA are signed up to a framework that intimately reflects the perspective of Ofgem, when Ofgem's retail energy policy is the leading candidate

for a feature having an adverse effect on competition. That policy urgently needs to be the subject of independent review.

Under previous statutory arrangements, the CC would approach a market investigation in an entirely independent way. But as from 1 April 2014 the OFT and CC will be combined into CMA. It will be for CMA to decide how to proceed, whether to instigate a market investigation, and how to conduct it. How then can CMA independently evaluate the evidence that emerges from this investigation when it is already committed to a particular framework that has the limitations identified above?

It might be said that Board members of a market investigation group would not be involved in the decision to refer a market for investigation, and that each market investigation group may determine its own procedure. So if the retail energy market were referred for a market investigation, the group would not be committed to the framework that CMA has hitherto proposed. It could adopt an entirely independent and uncommitted approach and take a fresh look at the evidence. But are the nature of the approach, and the evidence and how it is presented to the group, entirely independent of the staff team that prepares material for the group and translates its deliberations into a report? How then is the importance of independence to be reconciled with the latest statement from CMA?

1.22 At operational (staff) level, in order to avoid unnecessary duplication and to facilitate an efficient end-to-end markets process, the CMA would normally expect to have a degree of case team continuity by retaining at least some of the market study case team to work on the larger market investigation case team when a matter is referred. [A footnote adds:] In the case of a market investigation referred to the CMA by a regulator, some of the market study case team may be seconded to the CMA to be part of the relevant market investigation case team.¹⁹

How can a market study case team seconded from Ofgem expect to forget the framework that it has hitherto developed and approach a CMA market investigation with an open mind? In the event that the investigation yields a CMA report critical of Ofgem, how can such a team return to its former colleagues at Ofgem? Secondment of some of the market study case team would surely place an intolerable and unreasonable burden on the team members and institutions concerned.

The CMA is rightly committed to ensuring that there is no compromise to the need for a fresh and independent review in all market investigations. It seems unfortunate that it is a co-proposer of what is essentially Ofgem's competition assessment. In confirming that any market investigation group would not be committed to the framework document that has been issued in CMA's name, it would seem important also to confirm that CMA would not look to second to its case team any of the Ofgem staff.

¹⁹ *Market studies and market investigations: Supplemental guidance on the CMA's approach*, CMA3, January 2014.