

**The CMA energy market investigation, the well-functioning market, Ofgem,
Government and behavioural economics: executive summary**

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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. The energy market, and Ofgem’s regulation of the retail sector, remained controversial. In June 2014 Ofgem referred the market for investigation by the Competition and Markets Authority (CMA). In July 2015 the CMA published its *Provisional Findings* and *Possible Remedies*. 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.
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 asks: 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. I have shared that concern, and also expressed apprehension about the competition *Assessment Framework* that Ofgem, the 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. These concerns are shared by other former GB energy regulators.
5. The first part of this paper explores certain aspects of the CMA’s approach, starting with its concept of competition and its interpretation of the ‘well-functioning market’ as a benchmark against which a potential adverse effect on competition is measured. The energy market investigation defines the well-functioning market explicitly, as a sort of ideal. It asserts that prices in a well-functioning market are driven down to the level of “efficient costs”. Excess charges to customers include not only excess profits but also “inefficient costs”.
6. These aspects were not present in the work of the previous Competition Commission (CC). Rather, both these concepts originate in “Ofgem’s vision” and other proposals as set out in the December 2013 *Assessment Framework* prepared by Ofgem with the assistance of the CMA. From there, both concepts can be traced back to Ofgem’s 2008 *Probe Initial Findings*.

7. This raises two questions. First, whether Ofgem's lead role in preparing the *Assessment Framework* with the CMA gave Ofgem's thinking undue influence in the subsequent CMA investigation. Second, whether the definition of the well-functioning market as a 'vision' with efficient costs is consistent with the CMA's *Guidelines* and the Enterprise Act 2002, that required the CMA to assess markets based on competition criteria rather than public interest considerations.
8. Other factors might be leading both Ofgem and the CMA towards essentially the same approach. 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. The second part of this paper therefore examines the evolution of 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. Noticeable features are the multiple steps taken by Government to influence or modify regulatory and competition authorities, and the increasing influence of behavioural economics, not least via the OFT.
9. The Coalition Government wanted to ensure that "the regulator's decisions would be aligned with the Government's strategic policy framework", and said it would be "paramount to keep customers engaged in the market". It created the CMA to "play a leading role in achieving the Government's over-arching objectives and desired outcomes". Its Steer to the CMA indicated that the CMA should approach its analyses and remedies by focusing on consumer behavioural issues; should investigate sectors like the energy sector, and should work with the sector regulators, including by "actively supporting regulators' analysis". The Government then brokered the joint preparation of the *Assessment Framework* and *State of the Market Assessment* by Ofgem with OFT and the CMA. As a result, although the independent panel members made up their own minds, the similar approaches taken by Ofgem and the CMA energy market investigation to date are precisely as intended by the Coalition Government. They also reflect the common influence of behavioural economics thinking.
10. The third part of this paper notes that in May 2015 the new Conservative Government's Steer to the CMA removed the direction to focus on consumer behavioural issues and to support regulators' analysis. Instead, it emphasised the importance of removing unnecessary regulatory burdens. This reflects a changing political current and is consistent with previous advice to the CMA and evolving thinking and experience with behavioural economics. The CMA energy market investigation should reconsider its *Initial Findings* and *Possible Remedies*, and revisit its calculations of excess charges. The CMA itself will need to consider the implications of the new Steer, for individual investigations and for the Guidelines, where there is presently a disproportionate emphasis on (eg) customer switching. Another avenue of enquiry could usefully be a reconsideration of the nature, evidence and implications of behavioural economics for regulation and competition policy. A more balanced approach may now be emerging at the political level and the CMA is well placed to translate this into thinking and practice by regulatory and competition authorities. Whether this will be reflected in the final reports on *Energy* and *Retail Banking* remains to be seen.