



## Senior Civil Service Survival Kit

### Part 6 - Competition Policy

You are more than likely to need to understand the basics of competition policy at some time in your career.

This could well be because most governments try to encourage competition - between businesses, between schools, between civil servants; and so on. But competition favours those 'with sharp elbows' and this group seldom includes the poor and the vulnerable. There needs to be a balance. This important policy issue is discussed in Chapter 1.

Next, there is a rich ecosystem of regulators charged with policing competition in business and other environments. (Americans refer to this as **antitrust**.) You may need to have a basic understanding of how they operate, especially as they may stop you implementing what might otherwise seem sensible policies. Here are the main areas of activity:

**Chapter 2 - Mergers**

**Chapter 3 - Abuse of Dominance**

**Chapter 4 - Cartels**

**Chapter 5 - Utility Regulation**

**Chapter 6 - Private Actions**

**Chapter 7 - Market Investigations**

For completeness, I should mention that there are two other competition policy areas which are outside the scope of this handbook:-

*Intellectual Property Law*, such as patent protection and copyrighting, grants time-limited monopolies to designers, inventors, authors etc.

'State Aids' - is shorthand for Government and local government protection, preference and subsidies. Our own state aids - such as support for our vehicle and steel industries - can form a valuable element of industrial and social policy but they should be deployed as little as possible as do distort competition and can delay necessary economic adjustments.

If the government believes that overseas competitors are excessively subsidised and so competing unfairly with UK businesses then it can impose import duties to increase prices to where they should be. *Anti-dumping duties* are imposed on individual importers who are selling stuff below prices that they charge their domestic customers. Countervailing duties are imposed on all imports from specified countries so as to offset the benefits derived from subsidies.

For background, you might like to read an *Introduction to Regulation* - Part 5 of this Handbook. And there is much more detail about regulation generally, and competition policy in particular, on the *Understanding Regulation website* ( [www.regulation.org.uk](http://www.regulation.org.uk) ).

### 6.1 Competition

Competition is a key driver of innovation, productivity and the efficient functioning of the modern economy. These factors in turn drive improvements in GDP and the external trade balance. But unrestrained competition can impose unacceptable costs on society, and in particular on the vulnerable. Here are the competing considerations:-

#### The Case for Competition

Much modern policy making is based on the assumption that it is generally a good thing if businesses, universities, schools and hospitals compete hard with each other. It encourages what Joseph Shumpeter called 'a perennial gale of creative destruction', encouraging the efficient allocation of resources, forcing individual organisations to be efficient and innovative and to meet the needs of their customers, students and patients. This efficiency and innovation together ensure that choice is maximised, novel products come to market as soon as possible, and prices and service standards meet the needs of most customers. Even in the health sector, reduced competition - as a result of hospital mergers - has been shown to damage patient care.

Governments in all modern economies have accordingly developed a range of policies which seek to balance one need (to grow large and efficient companies) against the other need (to protect customers against exploitation).

Competition is such an important driver of economic performance that most countries in the world, including all countries in the European Union, have created competition authorities with strong legal powers aimed at preserving or increasing the extent of effective competition within their borders.

Competition is also good for suppliers and workers. The former need to be able to sell to companies that are innovative and thriving; both need to be able to seek other buyers or employers if dissatisfied with the way they are being treated. And the choices made by large numbers of citizens are usually much better than decisions made by politicians or bureaucrats when it comes to the allocation of scarce resources.

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There is also the point that markets don't pass judgment on the preferences they satisfy. Markets don't wag fingers. This is quite liberating.

Stephanie Flanders, reviewing a book by Tim Harford, summarised the virtues of competition in this way:

Why do economists like markets? ... Because, as Harford, explains, when a market is freely operating, everyone is forced to tell the truth. ... In a perfectly efficient market, the coffee shop can't lie about how much it cost them to make your coffee, because there would soon be a competitor next door selling it for less. And I can't pretend I don't really want that tall decaf latte I ordered, because the fact that I was willing to pay £3.50 for it showed the world I wanted it rather a lot. The result is that the right things are made in the right quantities and they go to the people who value them most. This is the idea of a perfectly efficient market, in which neither buyers nor sellers have any market power and lots of other crazy conditions are met, which critics rightly point out bear little relation to the real world. But Harford is good at showing why the efficient market story is still a useful one, and why rejecting markets has a cost.

### **But ... competition can lead to inefficient allocation of resources.**

This is particularly obvious in the case of transport where it can make a good deal of sense for operators to cooperate. It is very difficult, for instance, to travel north/south across London, Manchester and Glasgow because competing railway companies saw no point in joining their networks beyond their terminal stations.

**And ... competition favours those with sharp elbows:-** those who can shop around and who can force themselves to the front of the queue for excellent services, including education and healthcare. This group does not include the poor, vulnerable and other disadvantaged.

Michael Sandel, in *What Money Can't Buy*, points out that inequalities of wealth and income wouldn't matter very much if all they led to was the ability to buy yachts, sports cars and fancy vacations. But as money has come to buy more and more - political influence, good medical care, a home in a safe neighbourhood, access to elite schools - the distribution of income and wealth looms larger and larger.

Mr Sandel also points out that market reasoning tends to empty public life of moral argument. It is one thing to allow fast tracks at Disneyland. But private health care can start to shunt everyone else into long waiting lists. Ticket resale sites - and selling TV rights to major sports - can change the character of what would otherwise be important social events. And some environmental policies (such as tradable pollution permits and carbon trading) work by allowing wealthier folk to bribe poorer people to make unattractive sacrifices.

Another problem is that free (competitive) markets often fail to take account of the social costs that they impose on others - such as on the environment. That is why competition needs to be constrained by sensible environmental and other regulation. And let us not forget the huge costs that can be imposed on the rest of us by the failures in the financial markets that led to the 2008 financial crisis, and more recently to the problems associated with hyper-competition such as high frequency trading.

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Just as important, perhaps, is the fact that, although competition is often the best way to ensure the lowest *average* prices and highest *average* service quality, it carries no guarantees about what particular outcomes will emerge, nor about which particular customers (or providers) will win or lose from the process. Competition in the energy industries, for instance, has successfully reduced prices in general, but it has particularly rewarded those who use more energy, can shop around, and can pay by direct debit. Disadvantaged individuals may therefore need to be protected by targeted regulation, whilst bearing in mind that this imposes a sort of tax on others - some of whom may themselves not be very wealthy.

So, as competing companies can sometimes behave very badly towards certain consumers, it is vital there is strong consumer protection legislation which is effectively enforced. Equally, consumers must not be over-protected from being able to make (what appear to outsiders to be) bad choices. Companies must be free to innovate in all sorts of ways, including offering products and packages which may not objectively appear 'better' than existing offerings

### Competition in Health, Education etc.

Competition in public services, such as health and education, is also heavily constrained by the following considerations:

- Expensive services (such as cancer treatments and university courses) have to be made available to the least well off in our society, not just those who can afford them.
- But the sharp elbows of the middle class often ensure that it is only the well-informed and/or the well-networked and/or the better off that can make full use of the ability to switch to a better school, or identify that excellent surgeon.
- The ability to choose a supplier has to be matched by there being a multiplicity of suppliers, which is hard to arrange in smaller towns and in rural areas
- There has to be sufficient spare capacity to accommodate transferring students and patients, and that spare capacity (under-used teachers, wards, doctors) has to be paid for by someone.
- Unsuccessful institutions have to be allowed to reduce capacity as they lose their students and patients - but that always runs into serious opposition, including from staff and from the students/parents and patients that remain.
- And the customer might not always be right. The doctor with the best bedside manner might not be familiar with the latest most effective treatments. The university that most effectively sells itself to 17 year olds might not employ the best teachers. Even more worryingly, its teachers might mark generously so as to avoid upsetting students whose opinions will be passed on to those thinking of following in their footsteps.

Public service competition therefore needs quite firm, clear and occasionally complex regulation if it is to offer net benefit.

## 6.2 - Mergers

The most obvious way to stop firms gaining too much market power is to prohibit mergers which seem likely to result in a **substantial lessening of competition**. This leads to the most common piece of competition jargon:- '**the SLC test**' as in "did they find an SLC?".

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All competition regimes exempt smaller mergers from scrutiny, although the test of size varies from country to country. In the UK, mergers are exempt from scrutiny if the *turnover* of the firm being taken over is £70m or less and the combined firms will have no more than 25% *market share*.

Competition legislation is quite distinct from the Takeover Code. Companies that bid to acquire UK companies whose share prices are quoted on a stock exchange must comply with the complex rules in the Code, which is enforced by the very powerful Takeover Panel - a statutory body. This system is designed to ensure that shareholders are treated fairly, are not denied an opportunity to decide on the merits of a takeover, and are afforded equivalent treatment by an offeror.

Merger Control aims to prevent firms gaining market power as a result of acquiring control of competitors. In the UK, the Competition and Markets Authority (CMA) reviews all significant mergers with a view to prohibiting those that are likely to result in a **substantial lessening of competition**. Smaller mergers are exempt from scrutiny – i.e. if the turnover of the firm being taken over is £70m or less *and* the combined firms will have no more than 25% market share. But mergers that create a company with a combined market share of more than 25% are often allowed as long as the market remains competitive and/or it is relatively easy for new firms to enter the market. But lower thresholds may be appropriate in the tech sector, for instance, where large companies have been known to eliminate small competitors by simply buying them.

The exemption for small mergers can be problematic. One firm can grow to dominance by acquiring lots of small competitors, such as veterinary practices. Each merger is exempt from scrutiny but the long term consequence of such 'roll up' strategies can be very bad for consumers.

**Structural remedies** (e.g. banning a merger) are much preferable to behavioural remedies, under which the merging companies will make all sorts of apparently binding promises to behave properly in future so as to enable an otherwise objectionable merger to proceed. The trouble is that such promises are hard and costly to monitor and, some years later, hard to enforce, especially when circumstances have changed.

**Behavioural remedies** experts generally follow these sensible rules:

- Be precise: Avoid generalisation such as “fair, reasonable, non-discriminatory”
- Avoid circumvention: design remedies so that firms cannot find their way round them:
- In particular, remember the PQRS trade-off. Those with market power can make money by any combination of raising **p**rices, cutting product **q**uality, providing an unnecessarily limited **r**ange of products, and providing poor **s**ervice. It is seldom possible effectively to control only one (or two, or three!) of these.
- Consider, too, whether the remedy would work if the firm were to launch new products, or changes specifications, attract different customers, or enter new markets?
- Limit distortion as far as possible. Try in particular to avoid remedies which override competitive market signals or encourage adverse behaviour. Explicit price controls, for instance, make it harder for new competitors to enter the market.
- Ensure active monitoring and tough, speedy enforcement:
- Avoid information asymmetries (i.e. poorly informed customers), and complexity.

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- Be aware of specification & design risks such as changes in the market, input costs, or technology.

### National Champions & Other Significant Companies

It is important to note that, outside 'public interest' areas -see further below - neither the Government nor the CMA can block a takeover of a 'national champion' other than on competition grounds.

Ministers do come under pressure to "do something" to protect jobs and investment (such as investment in R&D) when significant UK companies might be bought by large overseas "predators". In practice, the purchasers are often willing to discuss their plans with the Government and others, and give commitments, but these are generally worthless. Kraft, for instance, was heavily criticised for breaking a promise to keep open Cadbury's Somerdale factory in Somerset following its successful takeover of that British company. And it was far from clear that Pfizer could be kept to its promise to keep 20% of its worldwide R&D workforce in the UK, had it been able to buy AstraZeneca in 2014.

For a long period after the Second World War, merger control decisions in the UK took into account the '*public interest*' in their consequences, including most obviously whether significant unemployment might result from a merger. But in 1984 Secretary of State Norman Tebbit announced what became known as *The Tebbit Doctrine* which was that most (*not all*) second stage references to what is now the Competition and Markets Authority (the CMA) would be made and decided primarily on competition grounds. This doctrine was affirmed by later Secretaries of State and eventually incorporated in legislation.

There are a number of 'public interest' areas where the appropriate Secretary of State can issue an '*Intervention Notice*' so that (s)he takes the appropriate decision rather than the CMA.

### *Financial Services*

This area was added in late 2008 when the UK financial services industry appeared close to meltdown in the wake of the worldwide financial crisis and the collapse of the UK's Northern Rock bank. It allowed mergers that would otherwise be prohibited.

### *Businesses with a role in public health emergencies*

This area was added in June 2020 to deter takeovers of companies that are involved in combating, or mitigating the impacts of, public health emergencies such as the COVID-19 pandemic. This power could most obviously be used to block a foreign takeover of a company that was developing a potentially valuable vaccine - and to ensure that the vaccine was first made available to UK citizens.

### *National Security - and Infrastructure*

The *National Security and Investment Act* became law in early 2022. It requires mandatory notification of proposed takeovers in 17 sectors including defence, energy and transport. The

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government said that it expected to receive over 1000 notifications a year requiring c.100 detailed reviews but probably only a small number of prohibitions.

### *Media Plurality & Broadcasting Standards*

This area includes TV, radio and newspaper mergers. The legislation is very complex but, in short, the Secretary of State cannot intervene in the decision whether to block a merger on competition grounds - this decision is still taken by the CMA - but (s)he can decide whether the merger is against the public interest because of it might reduce public access to a range of freely expressed views in the media, and/or to accurately presented news.



## 6.3 Abuse of Dominance

We are all delighted when firms do something special to retain our business - not just by being efficient and customer friendly, but also by offering volume discounts ("*three for the price of two*", "*buy one, get one free*") and loyalty discounts such as airmiles, reward cards, Nectar cards and Clubcards.

But there comes a point when such behaviour begins to trap us. A large company may, for instance, temporarily reduce certain prices so as to squeeze a smaller rival out of business. Or it may refuse to supply a customer who threatens to start buying part of their supplies from a smaller competitor. Such behaviour is, in law, an abuse of market power and can lead to the imposition of large fines of up to 10% of turnover in all of the relevant years.

Companies are guilty of **abuse of dominant position** if competition authorities such as the CMA can show (a) that a company is dominant in their market, and (b) that they have taken steps to eliminate the limited competition that remains by unfair means, such as:

- **Price discrimination** - offering price reductions and volume discounts to those customers who may be tempted to leave you for a competitor.
- **Tying** - tying one product to the sale of another.
- **Refusal to supply a facility that is essential for all businesses attempting to compete** - The most obvious essential facilities are in the transport industry: docks, bus stations & airports.
- **Predation** (as in preying on a victim). This behaviour includes predatory pricing - the practice of dropping prices of a product so much that smaller competitors cannot cover their costs and fall out of business - and other predatory behaviour - e.g. running new bus services at frequent intervals so as to force a new competitor out of the market. It can be difficult to tackle predation because the initial behaviour (lower prices etc.) benefits consumers. Authorities therefore need to ensure that they do not fall into the trap of protecting competitors rather than protecting competition.

None of the above behaviours are objectionable, of course, if they are carried out by non-dominant companies that are aggressively competing to retain customers. It is also often the case that markets do not work well for reasons which are to do with the history or structure of the market, rather than deliberate misbehaviour by individual companies. In practice, therefore, competition authorities have to carry out complex economic analyses in order to prove that the beneficial consequences of the behaviour (such as price cuts) are outweighed by the negative consequences (the elimination of competition).

Abuse investigations are always very hard fought. One problem is that dominance is hard to prove, and abuse of dominance even harder, given that much 'abuse' is regarded as feisty competition when carried out by smaller firms. Another is that executives of larger companies under such investigation often feel very aggrieved and complain that they are being penalised for being successful and having grown so large. And then, of course, the fines can be very large and the word abuse suggests serious wrongdoing. Companies and their executives inevitably fight such accusations very hard indeed, and the courts require competition authorities to have strong



and compelling evidence. This in turn leads to such inquiries ending inconclusively and/or taking a very long time indeed: 4+ year inquiries are not uncommon.

The European Commission and the American authorities have had some luck with victories over **Microsoft**, for instance - see incorporating ('tying') their browser and media player into the rest of their software. Google, too, has been the subject of major investigations. But successful UK investigations are few and far between. Market Studies and Market Investigations, which do not require the CMA to prove wrongdoing, have been much more successful - see Chapter X below.

Finally, in this section, it is worth reminding ourselves that dominant companies often feel understandably aggrieved when criticised for engaging in behaviour that is thought perfectly acceptable when carried out by their competitors. There is, unfortunately for them, some truth in this joke:

You're gouging on your prices if you charge more than the rest.  
And it's unfair competition if you think you can charge less.  
But don't try to charge the same amount! That would be collusion!

So ... now on to collusion:-

### 6.4 Cartels etc.

It is illegal to enter into **agreements which prevent, restrict or distort competition**, unless specifically permitted by the competition authorities.

Franchise and similar agreements are often permitted, as is anonymised sharing of cost and other information, for instance via a trade association, is generally OK. But competition law prohibits supermarkets from agreeing a minimum selling price for alcohol, even though this would support the Government's alcohol policy. Similarly, competing railway and bus companies are not allowed to agree ticket prices on shared routes which can lead to very puzzled passengers.

Most other agreements not to compete are usually prohibited. Cartels are (usually secret) agreements not to compete, through price-fixing or market sharing or in other ways. Secret cartels are regarded as very serious crimes in the UK as well as in many other countries. Cartels are prohibited because they lead to customers paying more (and often much more) than they should for their products. Companies can be fined very large amounts (up to 10% of annual turnover for each year of the cartel) and individual company executives can in serious cases be sent to jail for up to 5 years and/or made to pay unlimited fines. In addition, customers can - at least in theory - seek compensation via 'private actions' in the civil courts - to get back the money they overpaid as a result of the actions of the cartel. (See Chapter X below)

It can be hard to prove that a secret cartel exists. There will be little if any written evidence, and all the members of the cartel have a vested interest in maintaining the secret. Competition Authorities (including the CMA in the UK) therefore generally offer **leniency** to the first cartel member to confess. Such **whistle-blowing** is a powerful weapon because one cartel member can never be sure that other members will remain silent, so the more nervous may quickly

confess. This has proved very effective in busting several secret cartels, and no doubt deters the creation of many more.

Other cartel offences include:

- agreements not to compete in each other's markets,
- 'pay and delay':- payments by one company to another in return for promises not to enter a market, and
- bid-rigging, including 'cover bidding' where two or more companies secretly agree that at least one of them will submit a bid that is deliberately high or of poor quality during a competitive tender process.

It is also illegal for organisations to consult each other about pay rates, for instance.

Possibly the most famous cartel investigation was carried out by the FBI into the international Lysine cartel. It became the subject of a Hollywood movie *The Informant* and two rather racy books. The FBI's surveillance videos can also be found on *YouTube* - search for 'Lysine'.

It is important to distinguish cartels from **tacit collusion** which happens when firms fail to reduce prices because they reckon that this would only cause their competitors to reduce their prices, so they would all be worse off.

### Retail Price Maintenance

Manufacturers used to be allowed to set retail prices, and withhold stock from any retailer who tried to compete with another retailer by selling at a lower price. But this retail price maintenance, which clearly prevented price competition, has now been illegal for many years. Limited RPM is however still allowed where thought necessary to deter price cutting achieved by making lower quality products - such as pharmaceuticals. It has also been allowed where thought necessary to stop small shops etc. being competed out of business by large rivals. It is worth noting, however, that the hard-fought abolition of RPM in the book trade does not seem to have destroyed that market. And, although legal RPM is still alive in pharmacies and pharmaceuticals, it is frequently criticised, not least for the damage it does to the finances of the National Health Service.

### Exemptions, including Block Exemptions

Agreements (such as franchising or sharing R&D) are exempt from prosecution if they contribute to improving production or distribution, or promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit.

An agreement may be individually recognised as exempt by a competition authority or a court and, in addition, certain types of agreement will be treated as automatically exempt if they meet conditions set out in a 'block exemption' regulation or order applicable to that category of agreements.

### Most Favoured Customer?

Although price comparison sites facilitate competition between suppliers such as hotels, they severely limit the ability of such suppliers to offer lower prices than shown on the comparison sites on which they pay significant commission. This tends to increase prices across the board. The CMA accordingly fined *ComparetheMarket* £18m in 2020 for preventing insurance companies from offering better deals through rival websites. The CMA had previously targetted price comparison websites whose *Most Favoured Customer* contract clauses had stopped hotels etc. from offering cheaper prices than those advertised through the price comparison sites.

### 6.5 Utility Regulation

Most countries, including the UK, have Economic Regulators which act as a substitute for competition where there is limited competition or a natural monopoly. This is often the case in the utility industries where companies often have a natural monopoly in supplying energy, water etc. via wires and pipes which are expensive to duplicate.

Most of us think that such regulation is entirely focussed on protecting customers setting by setting price controls. It is, however, a lot more complicated than that.

#### Price, Quality, Range, Service

No-one ever buys a product or service just because it is cheap. At the very least, we expect that it will be delivered to us within a reasonable time, and will not harm us. In regulators' jargon, we endeavour to optimise PQRS - an appropriate combination of the price that we are charged (P), the quality of the goods etc. being sold (Q), the range of products and services made available (R), and the associated service that is offered to customers (S).

In an unregulated market, we choose the combination of P, Q, R and S that best suits us at a particular time. We sometimes choose to shop in a large supermarket, and we sometimes pop into our local store. We sometimes shop in a posh department store, and sometimes in Lidl. We sometimes have an expensive restaurant meal, and sometimes we drive through a McDonald's.

This fundamental fact poses real problems for those involved in utility regulation. Put positively, if market failure requires the imposition of regulation, then someone has to decide what quality, range and level of services should be provided, and at what cost. Put negatively, it is no use forcing prices down if the regulated company is allowed to provide a poor service to its customers.

This is an important issue for, amongst others:

- the water regulator which has the unenviable task of requiring water companies, such as Thames Water, to spend £ Billions to reduce water leaks and sewage discharges - with huge consequences for water bills;
- the energy regulator which requires licensees to provide electricity of a certain voltage and frequency; and to pay compensation for missed appointments; and
- the communications regulator which requires Royal Mail to meet certain prompt delivery targets.

More generally, however, **the trade-offs between price and non-price outcomes are better decided by elected politicians than by unelected regulators.** The extent to which water bills, for instance, should be increased to pay to reduce water leaks and sewage discharges is a (small p) political decision. It is also much better for politicians to resolve the tensions between the needs of present and future consumers - such as whether current consumers should pay more for their gas and electricity so as to facilitate investment in green/renewable technologies which will benefit future generations.

### How Are Price Controls Calculated?

Once Q,R and S have been determined, the maximum level of permitted prices is generally calculated by adding together the following costs, assuming that the company is, or will become, reasonably efficient, and will become more efficient year by year:

- Operating Expenditure,
- Capital consumption (depreciation and the like), and
- Financing Costs (the cost of capital - dividends, interest etc. - in principle, a fair return to investors for financing past and future assets).

UK regulators generally put pressure on efficiency by using an 'Inflation-X' formula:- prices are allowed to rise in line with an inflation index less an X% reduction each year to pass on to customers the benefit of improved efficiency. The most common formula has been RPI-X but CPIH is gaining ground in place of RPI.

This formula works well in a wide variety of circumstances, mainly because there are three main players in the regulatory contest: the company, its investors and the regulator. Regulated companies, implicitly - and sometimes explicitly - supported by their owners/investors, will often kick up quite a fuss in the final stages of a price control discussion, claiming that there is no way that the company can meet the regulators' '-X' efficiency target, and trying to browbeat or scare the regulator into making further concessions. But the owners/investors change sides when the new price control kicks in, and will generally put a lot of pressure on the company's managers to become even more efficient than required by the price control and so make extra profits.

It is interesting, in practice, to see how often the supposedly impossible efficiency targets have in practice been exceeded. There are often then complaints from consumers that the companies are making excessive profits (even within the price cap). The regulator will typically respond by cutting prices yet further in the next price control period. This is sometimes done by imposing an initial  $P_0$  price cut, followed by the usual cuts of RPI-X % pa. The company then responds by finding yet more cost savings .... and so on, to everybody's benefit?

Note, though, that this merry dance hides a great danger. John Kay points out that many - and sometimes most - people who work in utility companies are employed to stop things going wrong or to fix them when they go wrong. If all those employees were sacked then water and electricity would continue flowing whilst costs fell and share prices rose, along with executive remuneration. And the Prevention Paradox (see Part 1 of this handbook) would ensure that no attempt would be made to change course - until customers were poisoned or there was an extended failure of supply.

### Low prices ... or ... Competition?

This is a working draft of a handbook whose target audience is civil servants about to be, or newly promoted into the Senior Civil Service. It would be enormously helpful if readers would comment on the text. Are the tone and content broadly right? Any obvious errors or omissions? Please send comments to [ukcs68@gmail.com](mailto:ukcs68@gmail.com).

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There is another wrinkle, which causes many utility regulators to lose sleep. They all want to encourage competition, if that is possible. But they also want low prices unless and until there is sufficient competition. But low prices make it very difficult for new companies to enter the market and compete with the incumbent. Some regulators therefore do not apply as much downward pressure on prices as might be expected by anxious customers.

A variation of this problem is to be found when an incumbent offers lower prices to some of its more important customers. This looks like it might be abusing its dominant position - see 6.3 above. But it is a brave regulator that insists that a company may not charge less for its services.

This was a live issue in 2023 when BT/Openreach was eventually allowed to offer lower prices to Sky etc. if they used full-fibre for new networks. Ofcom eventually decided that this was not anti-competitive despite fierce opposition from Virgin Media and others.

### Revenue Forecasts

Regulated companies will sometimes forecast reductions in customer numbers/revenue, such as fewer passengers following the Covid pandemic, or fewer hard copy letters following the introduction of email etc. They then claim that they need a price rise to cover their fixed costs. There can be something in this argument but most regulators give it short shrift. The normal response to losing customers is to cut prices to attract them back, not increase them. Costs are seldom as 'fixed' as the companies will argue. And utility companies, with customers who cannot stop buying their product, face many fewer commercial risks than their non-regulated counterparts.

### The Cost of Capital

Price controls in capital intensive industries - and most utilities are highly capital intensive - are greatly influenced by the forecast cost of financing their operations. Regulators approach this by estimating the cost of risk-free borrowing, which ought to be around the cost of government borrowing - that is the yield on gilt-edged securities. They then add a premium to reflect the cost attributable to the additional risk of investing in that industry.

Financing costs are assessed by applying an appropriate rate of return (the *Cost of Capital* - see further below) to the *Regulatory Asset Base* (the RAB). There is often much nerdy argument about what assets should and should not be in the RAB, and the appropriate cost of capital - but huge sums of money (and huge consequences for customers) depend on the answers to these questions

This estimation clearly has to be done, and the amounts at stake mean that the process is hard fought, for the scale of capital investment in some industries means that even a 0.1% shift in cost of capital can hugely increase or reduce allowed prices - and hence profits. But no-one can ever be happy that they know the right answer. Professor Alan Gregory, writing in 2007, noted that studies had shown that the prospects for being able to estimate the cost of capital with any degree of accuracy were fairly bleak, and that even 'fairly bleak' might be an understatement.

Even so, regulators seem to have been caught out by the falling cost of risk-free borrowing since the early 2000s. One commentator estimated that this led to a transfer from customers to shareholders which cumulatively reached £s tens of billions. Regulators pointed out that the risk

could have fallen the other way, and customers could then have benefitted greatly. But this is to ignore the fact that regulated companies can usually apply to re-open price controls should significant unfavourable movements result which increase their costs significantly. P

### Risk Allocation

Utility companies sometimes have to make huge investments which can only be justified if they will be used and paid for over decades. Financially, therefore, they are very risky investments, however socially and economically sensible they may seem. Heathrow's third runway and Thames Water's Tideway Tunnel are good examples. How should this risk be allocated between investors, customers and wider society?

To the extent that effective competition cannot (yet?) be achieved, and to the extent that politicians don't want to take such decisions themselves, the regulator has to allocate risk between investors, customers and society more generally. Their general aim is to allocate risk to those best able to manage and/or bear it. Regulators may therefore need to require current customers to meet the cost. This leads to current air passengers being asked to pay for Heathrow's third runway, for instance, even though they will probably never use it themselves. Much the same applies to investment in water infrastructure.

### Access

It is generally the case that a new entrant into a market, seeking to attract business away from an incumbent operator, will need to be given access to certain shared and/or 'downstream' services. (Downstream services are those nearer the final consumer.) Examples of facilities and services that might need to be shared include pipes and wires, railway tracks and postal deliveries. Access generally needs to be enforced by a regulator keen to encourage competition.

It is usually necessary for the regulator to set the prices to be paid for use of those services, so as to ensure that the incumbent operators do not charge their rivals so much that new entrants cannot compete. A number of different approaches can be taken including

- the **average** cost of providing the service, and
- **retail minus** (aka *the Efficient Component Pricing Rule* (ECPR)) under which the incumbent thus recovers all his common and fixed costs, including 'sunk' costs, as well as a return on capital.

In practice it usually makes more sense to adopt a third approach:- **cost plus**. This involves calculating the marginal cost of providing the service - assuming the incumbent is efficient - and then adding a contribution to the incumbent's overheads, but excluding costs which are personal, so to speak, to the incumbent. Such excluded costs will include sales and marketing, corporate head offices, and directors' salaries. This approach can lead to surprisingly low access prices, as the marginal cost in a network industry can be very low, whilst bloated incumbents often have high central corporate costs. This cost plus approach can therefore be a very good and essentially fair way of encouraging access by new entrants.



## 6.6 Private Actions

It would obviously be good if the victims of cartels and abuse of dominance could easily and successfully claim compensation from their suppliers, for this would counteract the economic harm that had been done by the cartel. Indeed, many in government hope that such 'follow on' private actions might over time allow the competition authorities to devote less resource to cartel busting. There was a feeling that larger companies should be left to pursue their cartelised suppliers through the courts, thus cutting the cost to the taxpayer and perhaps also acting as a much greater deterrent to future cartels.

It has in practice been difficult for individual customers to successfully mount such private actions. The Government has therefore fairly recently introduced legislation intended to make it easier for businesses and others to bring '*collective proceedings*' (often called *class actions*). The necessary legislation in particular permits '*opt-out*' class actions, as a result of which all claimants would eventually benefit (if the action is successful) even if they knew nothing about the legal action.

The first significant collective action was launched in September 2016, on behalf of its many millions of card-holders, when **MasterCard** was sued for £14 billion. The European Commission had previously found the company guilty of abusing its dominant position by imposing excessive charges on the use of its credit and debit cards. Several retailers had successfully claimed follow on compensation.

There have since been a number of other lawsuits, underwritten by cash-rich litigation funders in return for a slice of any compensation. Sony PlayStation, for instance, is being sued for up to £5bn over allegations that it abused its dominant position and overcharged nearly 9 million gamers. Other litigation involves BT, Amazon, Google, Meta/Facebook and Apple.

## 6.7 Market Investigations

What can be done about companies that have grown very powerful and face limited competition? As we have seen (above) it is very hard to show that they are abusing their dominant position, and even successful abuse investigations take many years.

The good news is that in the UK, (though not in most other countries) it is possible for competition authorities to investigate and remedy problems in markets which do not appear to be working well. The CMA or another regulator first carries out a **Market Study** following which it can either make recommendations to the industry or to government (e.g. for regulatory action), or it can decide to carry out a full **Market Investigation**.

The CMA has extensive powers to remedy market failures by imposing behavioural conditions or forcing companies to sell part of their business. These very strong powers are in practice used quite rarely, but they can be valuable where a market appears to be failing, or where privatisation has created a company with significant market power. They were introduced after the Second World War in order to break up the cartels that had been a necessary feature of the wartime economy. Here are two examples of their recent use.



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- The CMA's predecessor authority investigated UK airports between 2007 and 2009 and required BAA plc (which owned many of the previously privatised airports) to dispose of Gatwick, Stansted Airports, thus increasing competition in the South-East of England, including for Heathrow, which BAA retained. BAA were also required to dispose of either Edinburgh or Glasgow Airport, this increasing airport competition in Central Scotland.
- One high profile Market Study - completed in 2019 - concerned the accountancy industry and the very large market share of the 'Big Four' companies in large audits. The CMA worked quickly and made some controversial recommendations to government, but it might have been better if there had been a more thorough Market Investigation which could have led so the CMA imposing its own remedies, rather than relying on politicians to take on significant vested interests.

**The CMA's powers** are in some ways quite extraordinary. They can make *Orders* which are legally binding on businesses that were not part of the original investigation. For instance they can require a range of businesses to publish or publicise particular information which the CMA believe would make the market work more effectively. BAA's lawyer claimed - probably accurately - that the forced sale of three airports was "*just about the largest individual forced transfer of land since the Reformation*".

Market investigation powers can be very useful (and necessary) when facing the power and complexity of today's 'Big Tech'. The EU's Digital Market Act accordingly gives the European Commission very similar powers.