

Competition in mixed markets: ensuring competitive neutrality

A working paper

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1 EXECUTIVE SUMMARY

- 1.1 Over the past decade there has been a rise in the number of mixed markets, by which we mean markets where state-owned enterprises, private firms and third sector organisations compete alongside one another. This paper is a response to the increase in mixed market provision and is designed for policy makers who are thinking about, or involved in, creating mixed markets.
- 1.2 In particular, this paper addresses the issue of competitive neutrality. Competitive neutrality is the principle that there should be a 'level playing field' between state-owned enterprises, private firms and third sector organisations in mixed markets.
- 1.3 The paper does not consider the issue of whether public bodies should be privatised or previously public markets should be opened up to competition. We have taken the market ownership structure as given and make no judgement on how it might be changed.
- 1.4 There could be a number of reasons for mixed market provision. In some cases, such as in health and education, previously public sector markets are being deliberately opened up to greater provision by private and third sector providers in an attempt to increase efficiency and/or deliver better products or services. In other sectors state-owned enterprises are trying to explore commercial opportunities, competing alongside existing private firm and third sector organisations. In each of these cases, the different objectives and approaches of state-owned enterprises, private firms and third sector organisations can be beneficial for consumers. Competitive neutrality is not about trying to remove these differences.
- 1.5 However, where competitive differences do not reflect underlying differences in costs or objectives – such as where regulations or taxes apply differently to private, public and third sector providers – then there is a risk that the market will not operate effectively due to resources being used inefficiently. This could potentially lead to higher prices and reduced value for taxpayers.

- 1.6 Competitive neutrality is not only about potential disadvantages faced by the private and third sector when they compete against state-owned enterprises. While an absence of competitive neutrality can sometimes disadvantage the private sector, equally there are some cases where the public sector or third sector is at a disadvantage.
- 1.7 Competitive neutrality is a minimum condition for setting up effective mixed markets – ensuring that there are no artificial barriers to entry and that outcomes are efficient, given wider policy objectives.
- 1.8 The main barriers to competitive neutrality include:
- differences in regulation, taxation, and pensions treatment between different types of providers
 - incumbency advantages enjoyed by existing firms, such as access to information, pre-qualification and bid criteria, and transition costs, and
 - lack of clarity in the application of competition law.
- 1.9 Previous discussions both in the UK and internationally have considered how to achieve competitive neutrality in mixed markets. This debate suggests a range of different approaches, including:
- Making sure public procurers compare bids on a like for like basis. Many public services are procured by public agencies on behalf of users, and increasingly this procurement involves buying from mixed markets. It is important that public procurement reflects and corrects for differences between bidders that do not relate to true differences in costs or objectives between firms. More radically, some of the tax, pension and regulatory differences in treatment between state-owned enterprises, private firms and third sector organisations might be addressed directly. However, we recognise that wider policy objectives would need to be taken into account.
 - Ensuring good corporate governance for state-owned bodies that compete in mixed markets. This can help ensure that commercial

activities of state-owned enterprises are properly defined and distinguished from other activities.

- Application of competition rules to the behaviour of state-owned enterprises, private firms and third sector organisations regardless of ownership – ensuring that markets are opened up appropriately to competition.
- Overarching competitive neutrality principles to guide public sector behaviour in mixed markets. The clearest example of this is in Australia.

1.10 The UK has adopted several of these approaches. As discussed in this paper, there are good examples of public procurement practices which attempt to ensure competitive neutrality. The UK also has some corporate governance measures in place across mixed markets to encourage competitive neutrality.

1.11 There is however currently limited consistency in the application of competitive neutrality approaches by different parts of the UK Government. At a minimum there should be opportunities to share best practice between departments. The sharing of information would allow departments to learn from one another's experiences and would mean that if new mixed markets are created, this could be done in a way that ensures that the best provider of the good or service is chosen, based on an equal evaluation between potential providers.

1.12 There may be advantages in developing some overarching competitive neutrality principles to be followed across the public sector. This would give a clear sense as to the benefits of competitive neutrality and provide a clearer framework within which to design sector-specific approaches.

1.13 The UK Government should also aim to evaluate its different approaches to competitive neutrality to see whether these have delivered better outcomes. This would ensure that any principles adopted across the public sector are grounded on a strong evidence base.

2 INTRODUCTION

- 2.1 This working paper is intended to summarise the current debate around competitive neutrality, particularly as it applies in the UK. It is not a market study, and has been conducted primarily using publicly available information and by speaking to a number of stakeholders.
- 2.2 Competitive neutrality has been an increasing topic of policy debate over the last five years or so. While the concept has been used in other countries for some time – most notably in the Australian National Competition Policy, which established competitive neutrality as a key principle – the recent discussion in the UK was arguably begun by the CBI paper *A fair field and no favours*.¹ This summarised the possible reasons for lack of neutrality between public, private and third sector competitors, particularly in the context of public sector procurement. It also drew on evidence from a number of sectors in the UK, such as health and prison services.
- 2.3 The Government subsequently considered competitive neutrality as part of the Julius Review of the public services industry (PSI)² ('The Julius Review').³ This found a lack of competitive neutrality in some public service markets, and argued that differences between different types of

¹ Sturgess, G, 2006, *A fair field and no favours, Competitive neutrality in UK public service markets*, the Serco Institute & CBI. Available at: www.serco.com/Images/Comp%20Neutrality_Prf6_tcm3-11584.pdf

² The Julius Review defined the public services industry to include: 'All private and third sector enterprises that provide services to the public on behalf of Government or to the Government itself', p i, BERR, 2008, *Public services industry review; Understanding the Public Services Industry: How big, how good, where next? A review by Dr. DeAnne Julius CBE*. Available at www.berr.gov.uk/files/file46965.pdf

³ BERR, 2008, *Public services industry review; Understanding the Public Services Industry: How big, how good, where next? A review by Dr. DeAnne Julius CBE*. Available at www.berr.gov.uk/files/file46965.pdf

providers created by Government policies or actions act as a barrier to effective competition.

2.4 The OFT has previously looked at competitive neutrality issues in the context of two market studies:

- The 2004 study on public sector procurement noted that best value principles require public and private bidders to compete on an equal basis and that a local authority must demonstrate that a public supplier 'offers as good as or better value than a private sector supplier. However, some suppliers have expressed concerns that when competing for a contract where a direct service organisation (DSO) [public provider] is present they are not competing on a level playing field. For example, suppliers have argued that local authorities sometimes set very short contract lengths to provide the DSO with a competitive advantage'⁴
- The 2006 study on commercial use of public information considered one specific example of the interaction between publicly owned firms and competition. Where public firms collect valuable information which could be used commercially, the OFT found that there was an economic benefit in making more of that information available for commercial use.⁵

2.5 The motivation for this paper is to draw together the current evidence on competitive neutrality across sectors, and look at possible ways of addressing any restrictions. It also fills a gap in the OFT's understanding of the interaction between private firms, third sector bodies and state-

⁴Short contract lengths does not allow supplier to recover their initial sunk costs. See paragraphs 3.33 and 3.34, OFT, 2006, *More competition, less waste: Public procurement and competition in the municipal waste management sector*. Available at:

www.offt.gov.uk/shared_offt/reports/comp_policy/oft841.pdf

⁵ OFT, 2006, *The commercial use of public information (CUPI)*. Available at:

www.offt.gov.uk/shared_offt/reports/consumer_protection/oft861.pdf

owned enterprises, which was identified as important in our recent *Government in Markets* paper.⁶

2.6 The paper is structured as follows:

- Chapter 3 explains what is meant by the term 'competitive neutrality'.
- Chapter 4 outlines why competitive neutrality is important in terms of market outcomes.
- Chapter 5 summarises some of the possible barriers to achieving competitive neutrality.
- Chapter 6 outlines the way in which these barriers might be tackled, and includes examples from the UK and other countries where different approaches have been attempted.
- Chapter 7 briefly looks at the issues raised where Government is opening up new markets to competition (as opposed to those where mixed markets are already established).
- Chapter 8 sets out possible ways forward to achieve increased competitive neutrality in the UK.

⁶ OFT, 2009, *Government in markets*. Available at www.oft.gov.uk/shared_of/business_leaflets/general/OFT1113.pdf

3 WHAT DO WE MEAN BY COMPETITIVE NEUTRALITY?

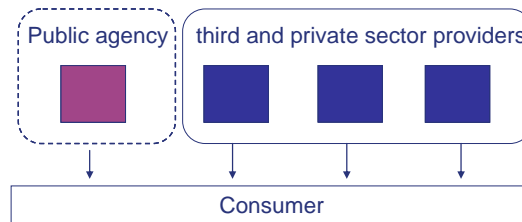
- 3.1 The defining characteristic of competitive neutrality is that no firm should have a competitive advantage in a mixed market purely as a result of its ownership or control. Where state-owned enterprises, private firms and third sector organisations might be competing alongside each other, competition should not be affected by ownership.
- 3.2 In the *Government in markets*⁷ paper the OFT set out ways in which Government has an influence on markets throughout the economy. Government participates in markets directly and indirectly: direct participation occurs when Government acts as a supplier or a buyer of goods and services. Indirect participation is achieved through the use of taxes, subsidies, regulation and influence, for example, information campaigns.
- 3.3 Competitive neutrality issues arise in two main contexts. First, in some markets, state-owned enterprises and/or third sector providers compete to supply final consumers directly alongside the private sector. This situation can be described as 'competition in the market'⁸. For example, some markets which were previously dominated by state monopolies have been opened up to competition. In these markets private, public and third sector providers compete to supply consumers. An example of this type of market is the provision of health care services where private and third sector hospitals directly compete with NHS hospitals for publicly funded patients. The OFT's recent report on choice and competition in public services addresses the issue competition in the market in areas such as health and education.⁹

⁷ Ibid

⁸ Competition in the market can be defined as how firms already in a particular market compete on a day to day basis to gain market share.

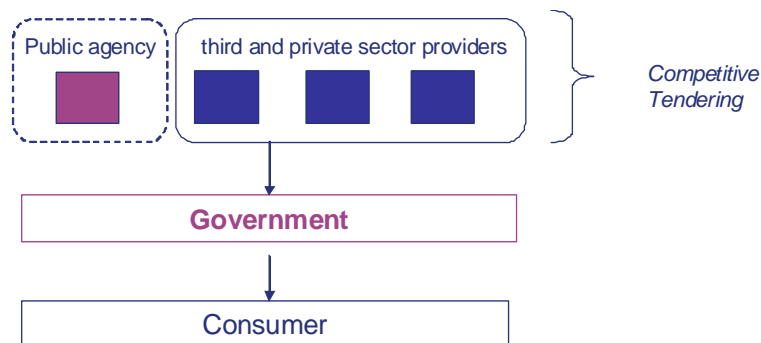
⁹ OFT, 2010, *Choice and Competition in Public Services: a guide for policy makers, A report prepared for the OFT by Frontier Economics*. Available at www.of.gov.uk/shared_of/business_leaflets/general/of1214.pdf

Figure 1: 'Competition in the market'



- 3.4 In other cases, public procurement takes place on behalf of final consumers. This can be described as 'competition for the market'.¹⁰ When the Government uses procurement to supply services it can frequently buy those services from private or third sector providers as well as in-house publicly owned bidders. Refuse collection is an example where the Government purchases goods and services from the private sector firms. In some cases there is also a Government supplier which competes with other suppliers, for example in the case of prisons.

Figure 2: 'Competition for the market'



- 3.5 Competitive neutrality does not mean that no firms can enjoy a competitive advantage. Competitive advantages can occur for a number of reasons, for example as a result of the size of the business. Large blue-chip companies will be able to borrow money at a lower interest rate than a small firm which has recently started operations. This difference in the cost of borrowing reflects the expected risk of a firm

¹⁰ 'Competition for the market' can be defined as how firms initially compete to supply a market

failing and is not related to competitive neutrality. Competitive advantages can exist at the same time as competitive neutrality. For example, it is possible for there to be competitive neutrality and for a particular firm to still have lower costs because of more efficient production techniques.

- 3.6 Competitive advantage helps drive the dynamic competitive process which means that more efficient firms expand and do well while inefficient firms lose customers and leave the market. The danger is that a lack of competitive neutrality artificially distorts these competitive dynamics and means that markets do not work as well as they might. This will result in some inefficient firms remaining in the market and some more efficient firms being unable to grow and innovate effectively. This inefficiency may lead to lower quality and higher prices for consumers and also to lower levels of innovation in the sector as a whole than would otherwise have been the case.
- 3.7 When considering competitive neutrality, we are interested in differences in costs or other parameters of competition which stem solely from differences in ownership or control. These might include, for example, differences in regulation, tax treatment, or public service obligations.
- 3.8 Though competitive neutrality most often concerns the advantages enjoyed by public undertakings, the principle is just as applicable to their disadvantages. These competitive disadvantages might include: greater accountability obligations, requirement to provide universal service obligations, reduced managerial autonomy, requirements to comply with Government wages, employment and industrial relations policies, and higher superannuation costs.¹¹ These conditions and obligations are generally imposed by Government in the interests of achieving wider policy aims, and it is for Government to balance those aims against any potential for distortion of the market in question.

¹¹ Taken from Hilmer, F, 1993, *National competition policy* (the Hilmer report). Available at: ncc.gov.au/docs/Hilmer-001.pdf

3.9 In any particular case it is likely to be difficult to determine whether the public body enjoys a net advantage or disadvantage. See Box 1 for an example of a market where the public operator suffers both competitive advantage and disadvantage.

Box 1 Liberalisation of the UK postal market

Liberalisation of the European postal market has allowed private mail companies such as TNT and Deutsche Post to enter the UK market in competition with the previous state monopolist, Royal Mail. While Royal Mail enjoys exemption from VAT¹², it suffers from a competitive disadvantage because it is required to offer a universal delivery service for a single price while new entrants to the market can choose which services to provide, for example, parcel delivery, based on expected profitability. We make no comment on whether these advantages and disadvantages are 'right' or 'wrong', but we use them simply to illustrate the difficulty that can arise when trying to assess whether a public body enjoys a net competitive advantage or disadvantage as a result of its ownership.

¹² TNT Post NV, a competitor to Royal Mail for mail services, challenged the UK's position on VAT in the High Court. This was referred by the High Court to the European Court of Justice (ECJ). TNT Post argued that, where the market is liberalised, VAT should be charged on all services to avoid market distortion. The ECJ upheld Royal Mail's exemption for universal postal services but concluded that it does not apply where Royal Mail's services are provided at individually negotiated prices. As a result, some postal services as supplied by Royal Mail, such as those that are individually negotiated or not subject to any price and regulatory control, which have been treated as exempt, will become liable to VAT. HM Revenue & Customs are currently in discussions with Royal Mail to establish precisely which of their services will be affected and further guidance will be issued once these discussions are complete.

4 WHY DOES COMPETITIVE NEUTRALITY MATTER?

- 4.1 Competitive neutrality is important because it affects the efficiency of mixed markets and firms' incentives to innovate. Public service markets (PSI) are large markets: the Julius Review estimated that in 2007/8 Public Service Industries (PSI) revenues were £79bn, generating £45bn in value added and employing over 1.2 million people. Health represented about a third of the total value followed by social protection (22 per cent), defence (12 per cent) and education (nine per cent) - since 1996 the PSI has as grown almost 130 per cent as a result of Government policy to increase the role of mixed markets in the economy.¹³
- 4.2 A lack of competitive neutrality has short and long-term effects. The short term direct effect is that contracts are not awarded to the most efficient providers so resources are allocated inefficiently. Any inefficiency in the allocation of resources will cause consumer detriment if it leads to higher prices and less choice than would be available in an efficient market. It is also likely to mean that taxpayers spend more on the provision of services than is needed.
- 4.3 In the long run there is likely to be a reduction in innovation and development of new, more efficient, production processes because any advances are offset by the competitive disadvantage faced as a result of ownership. As noted in our *Government in markets* report it is important that competition occurs as openly as possible: 'Where public sector bodies are engaged in mixed markets alongside private firms, it is important for the public bodies to ensure that they are not exploiting unfair advantages over the private sector and stifling innovation or improved efficiency that private firms may bring to the market.'¹⁴

¹³ p ii, BERR, 2008, Public services industry review; *Understanding the Public Services Industry: How big, how good, where next? A review by Dr. DeAnne Julius CBE*. Available at www.berr.gov.uk/files/file46965.pdf

¹⁴ p 42, OFT, 2009, *Government in markets*. Available at www.of.gov.uk/shared_of/business_leaflets/general/OFT1113.pdf

- 4.4 The wider economy benefits from competitive markets because they encourage greater productivity and innovation and preserve long term growth while continuing to provide greater value for money to the taxpayer. Competitive markets are not necessarily private or mixed. Competitive markets are those where the products or services are produced as efficiently as possible therefore delivering the best possible outcome for the consumer, which in some cases is the taxpayer.

Mixed markets

- 4.5 Since the 1980s some markets that were previously dominated by publicly-owned monopolies have been opened up to competition from private and third sector operators. In some UK markets, for example telecommunications, the state monopolist has been privatised but in other markets, for example prisons, the public sector still operates.
- 4.6 In line with many other countries, the UK Government has introduced mixed markets because it believes 'working in partnership with private and third sector providers ... [ensures] our goals of excellent, fair and cost effective public services are achieved.'¹⁵

The arguments for mixed markets

- 4.7 Private firms are usually assumed to maximise profit. The incentives for public and third sector organisations are more complicated: public operators have a range of incentives depending on the policy objective they are trying to achieve, for example they may try to maximise employment or output. Because of the diverse nature of the third sector, third sector organisations also have a wide range of incentives. These

¹⁵ Foreword by John Hutton, BERR, 2008, Public services industry review; *Understanding the Public Services Industry: How big, how good, where next? A review by Dr. DeAnne Julius CBE.* Available at www.berr.gov.uk/files/file46965.pdf

can be loosely defined as working to maximise their benefit to their users.¹⁶

- 4.8 These different incentives are likely to mean that different types of operators will deliver a different outcome even when competitive neutrality exists. Different types of providers will bring particular skills, for example private operators may have more streamlined management processes while third sector operators will have expertise about the specialist needs of the recipients of the public service.
- 4.9 Having a public operator in a market can also help provide the Government with more information about how the market works. Such information can facilitate more efficient price and quality regulation or more efficient tendering processes. One of the fundamental issues faced in the provision of public goods is the asymmetry of information between the authority commissioning the service and the provider of that service.
- 4.10 It is for the Government department commissioning the service to decide what they want to achieve when they contract out a particular public service. As noted in De Fraja (2009), 'the ownership of a firm or an agency will affect its objective, and different objectives will lead to different behaviours, which in turn might affect differently other firms or agencies in the industry. However, there is nothing intrinsically 'right' or 'wrong' in having one objective or another.'¹⁷

¹⁶ Under the Charities Act 2006, charities are required to operate only for the public benefit. They are required by law to limit their activities to those that are within charities objects and powers. Charities must also be independent of Government and other funders, trustees must act only in the interests of the charity and its beneficiaries, and trustees must make decisions in line with their duty of care and duty to act prudently. Source: p 6, Charity Commission, 2007, *Charities and Public Service Delivery: An introduction and overview*. Available at: www.charity-commission.gov.uk/Library/publications/pdfs/cc37text.pdf

¹⁷ De Fraja, G, 2009, *Mixed oligopoly: old and new*. Paper prepared for the Swedish Competition Authority 2009, Pros and Cons seminar on Pros and Cons of Competition in/by the Public Sector, held in Stockholm, 13 November 2009.

The value of competitive neutrality

- 4.11 Competitive neutrality is important in mixed markets. In many mixed markets goods and services are purchased by the Government. Good procurement means getting value for money – that is, buying a product or service that is fit for purpose, taking account of the whole-life cost.
- 4.12 In the UK more than £175 billion is spent every year on the goods and services required to deliver public services.¹⁸ The Government's objective is to achieve the best value for money through running an efficient procurement process for these goods and services. Value for money means finding the balance of cost, quality and choice that delivers the best outcome. The consumers of the product or service depends on the market in question, in some cases it will be a Government department and in others it will be members of the public, for example in the provision of unemployment services.
- 4.13 Running a competitive procurement process is good for consumers and the taxpayer because it means the most efficient organisation that delivers the best outcomes in terms of quality and cost will win the contract to provide the good or service.
- 4.14 The main evaluation of the effects of competitive tendering on public services is contained in the Julius Review: this found that competitive tendering in PSI markets has brought benefits to the UK economy with cost savings of between 10 and 30 per cent and no decrease in quality. The review gave no clear answer about the effects of mixed markets on consumer welfare. However it did conclude that partnership models¹⁹ were usually delivered on time and, when public sector over-runs were

¹⁸ p 3, HM Treasury, 2008, *Accelerating the SME economic engine: through transparent, simple and strategic procurement*. Available at: www.hm-treasury.gov.uk/glover_review_index.htm

¹⁹ 'Partnership models' are public-private partnership (PPP) and private finance initiative (PFI) models.

included in the comparison, were not more expensive than public provision.²⁰

- 4.15 The study found that the economic benefits occurred despite the lack of competitive neutrality. It may be that if there was increased competitive neutrality there may be greater benefits derived from competitive tenders in PSI markets.

²⁰ BERR, 2008, Public services industry review: *Understanding the Public Services Industry: How big, how good, where next? A review by Dr. DeAnne Julius CBE*. Available at www.berr.gov.uk/files/file46965.pdf

5 WHAT ARE THE BARRIERS TO COMPETITIVE NEUTRALITY?

5.1 There are significant barriers to achieving competitive neutrality in the UK. Barriers can arise during the direct competition between public, private and third sector operators or during procurement of goods and services by the public sector.

5.2 Key barriers to competitive neutrality are:

- differences in regulation, pension, and tax treatment between public private and third sector providers
- legal application of competition law, and
- incumbency advantages enjoyed by existing firms, such as access to information, pre-qualification and bid criteria, and transition costs

5.3 In this chapter we briefly consider each of these factors.

Regulation, pensions and tax treatment

5.4 The CBI in their report *A fair field and no favours*²¹ identified governance and regulatory arrangements as a source of competitive non-neutrality in mixed markets. This includes regulation, taxation, pensions and capital cost.

Taxation

5.5 Public, private and third sector operators will face different tax treatment as a result of their ownership structure. These non-discretionary cost differences can result in significant advantages/disadvantages for firms competing in mixed markets. For example, Corporation tax is applied to the profits of private sector operators. Public and third sector operators

²¹ See *A fair field and no favours, Competitive neutrality in UK public service markets*, the Serco Institute & CBI. Available at: www.serco.com/Images/Comp%20Neutrality_Pr6_tcm3-11584.pdf

on the other hand are exempt from paying tax on their surplus revenue. While there are clear reasons for these differences, it can distort firms' ability to compete on the same basis as not-for-profit organisations and may reduce private providers' incentive to invest.²²

- 5.6 The Office of Health Economics in their research on competition between independent and NHS providers found 'all else being equal, a Corporation tax paying entity would have to charge higher prices than would an NHS body or charity to achieve the same return on investment.' They estimated that Corporation tax can add between 2 per cent and 4 per cent to the total cost of for profit organisations.²³
- 5.7 Tax rules regarding VAT are also applied differently across public, private and third sector operators. There is the possibility of tax equivalence being introduced by central Government departments and agencies through accounting changes. However, the complexity of VAT rules means this is likely to require some deliberation. It is also worth noting that in some markets, for example postal services, UK VAT rules are affected by the implementation of a European Union (EU) VAT Directive. Any change of these rules would seem to require a change to the VAT Directive, which would require unanimous approval of all EU member states.

Pensions

- 5.8 Public providers do not have to explicitly recognise pension costs on their balance sheets when bidding for public sector contracts whereas private and third sector providers do. This can give public sector bid teams an advantage due to the different treatment they receive.

²² 'How Fair? Competition between independent and NHS providers to supply non-emergency hospital care to NHS patients in England' by the Office of Health Economics provides a detailed discussion of the effects of corporation tax.

²³ *ibid*

5.9 In the debate about competitive neutrality the issue of pensions is frequently mentioned. In the report *Counting the cost; Full cost comparison between public service providers* the CBI specifically highlights public sector pension costs as a 'major barrier to a level playing field in public service markets and therefore to market entry for providers in a number of sectors.'²⁴ The Ministry of Justice explicitly recognised the issue of public sector pension in its recent procurement process. See Box 3 on page 26 for more details.

Cost of capital

5.10 Public sector operators will typically be able to borrow capital at a preferential rate compared with private and third sector providers. This reflects private lenders' expectation that the taxpayer will 'bail out' public sector operators.²⁵

5.11 Where mixed markets exist, differences in the cost of capital can be a significant barrier to entry, particularly where the provider is small relative to the investment they are required to make to enter the market.

Advantages for public sector operators

5.12 The CBI also identified a number of sources that specifically relate to competitive advantages enjoyed by publicly owned enterprises.²⁶

²⁴ p 4, Walker, D, 2008, *Counting the cost; Full cost comparison between public service providers*, CBI. Available at: www.cbi.org.uk/pdf/CBICompetitiveNeutralitybrief.pdf

²⁵ This issue was cover in '*Northern Rock: The impact of public support on competition*' OFT 2009 Available at www.offt.gov.uk/OFTwork/markets-work/completed/northern-rock

²⁶ Although listed in the CBI's report the original list was developed by the OECD. p 5, Sturgess, G, 2006, *A fair field and no favours, Competitive neutrality in UK public service markets*, the Serco Institute & CBI. Available at: www.serco.com/Images/Comp%20Neutrality_Prf6_tcm3-11584.pdf

- **Subsidies from Government to fund public service obligations**, if used to cross-subsidise commercial activities. Such subsidies could create an advantage for the public operator if it means they have access to lower costs for their commercial activities as a result.
- **Access to data collected for public purposes**, where the public sector entity can use that data on terms more favourable than those available to the private sector. This issue was highlighted in the OFT's market study looking at the commercial use of public information (CUPI).²⁷ In the study the OFT considered the barriers facing private operators trying to access public information. One of the findings of the study was that much of the legislation and guidance that aims to provide for equal access to public information lacks clarity and is inadequately monitored.

Legal application of competition law

- 5.13 In principle the competition rules governing anti-competitive agreements and abuse of dominance apply to both privately and publicly owned enterprises equally wherever a public body is acting as an 'undertaking'. In practice, applying competition law to public bodies can be difficult where there is doubt as to whether, and in what circumstances, they are acting as 'undertaking' and therefore subject to competition law.
- 5.14 Some of the complexities involved in applying competition law to public bodies are illustrated in *BetterCare Group v Director General of Fair Trading*²⁸ which is discussed in Box 2 below.

²⁷ OFT, 2006, *The commercial use of public information (CUPI)*. Available at: www.offt.gov.uk/shared_offt/reports/consumer_protection/oft861.pdf

²⁸ Case No 1006/2/1/01 [2002] CAT 7, [2002] CompAR 299

Box 2: BetterCare

The OFT received a complaint from BetterCare Group Ltd (BetterCare), a UK provider of residential and nursing care that a UK Health and Social Services Trust had abused its dominant position by offering unfairly low prices and unfair terms in its purchases of social care from BetterCare. The Trust provided residential and nursing care to the elderly both directly and through a private contractor. Whilst the Trust charged for its services, it did not recover its costs in full.

The OFT considered that the Trust was not an undertaking for the purposes of the Competition Act 1998 when engaging in purchasing activity. On appeal to the UK Competition Appeals Tribunal (CAT) in *BetterCare II* the CAT²⁹ held that the Trust was acting as an undertaking, both in the purchasing of services from BetterCare as well as in the direct provision of elderly care.³⁰ The CAT's reasoning was that, in deciding whether the activity was economic in character, a key consideration was whether an entity is in a position to generate the effects which the competition rules seek to prevent.³¹

However, the subsequent judgments of the Court of First Instance (CFI) and European Court of Justice (ECJ) do not follow the same reasoning as the CAT in *BetterCare II*. In *FENIN v Commission* the Courts concluded that the nature of the purchasing activity had to be determined according to whether or not the subsequent use of the purchased goods is an economic activity.³² The CFI considered that where an organisation purchases goods, not for the purpose of offering goods and services as part of an economic activity, but in order to use them in the context of a different activity, such as an activity of a purely social

²⁹ At that time called the Competition Commission Appeal Tribunal or CCAT.

³⁰ Paragraphs 191-194, Case No 1006/2/1/01 [2002] CAT 7, [2002] CompAR 299

³¹ *Ibid* paragraph 190.

³² Paragraph 36, Case T-319/99 *FENIN v Commission*

nature, then it is not acting as an undertaking simply because it is a purchaser of those goods. This judgment was upheld on appeal to the ECJ.³³

There will only be further clarification on the scope of the application of the competition rules to state organisations through additional case law.

Incumbency Advantages

- 5.15 One of the largest sources of competitive non-neutrality relates to the advantages enjoyed by incumbent suppliers during the procurement for contract. Although, incumbency advantage is often concerned with the advantages enjoyed by public sector operators, it is equally applicable to the private or third sector. Incumbency advantages can occur in any industry that is moving from a monopoly/dominant operator provision to competitive tendering. This is not unique to mixed markets but is particularly prevalent because of the shift from in-house provision of services by government to outsourcing.
- 5.16 The Julius Review highlighted the following areas where there may be concerns during the procurement process resulting from incumbency advantages:
- **Pre-qualification / bid criteria:** In many cases Government demands that bidders have a demonstrable history in the area; this is to ensure bidders have appropriate expertise. This can, however, limit the ability of new entrants to break into markets.
 - **Lack of shared information:** Where there is a lack of information on current service levels or the costs involved, incumbents are likely to have an advantage over other bidders.
 - **Transition costs:** If a different bidder wins a contract they may face start-up or transition costs. Where these are likely to be significant,

³³ Paragraphs 25-26, Case C-205/03 P [2006] ECR I-6295, [2006] 5 CMLR 559

they could outweigh other cost advantages and thereby limit competition.

- 5.17 It may be possible for Government to overcome barriers in the procurement process. One example of a Government department's attempts to encourage competition is HM Revenue & Customs' (HMRC) actions during the tendering of IT services. In its 2004 procurement of the £3 billion IT outsourcing contract, ASPIRE, HMRC contributed to firms' costs of bidding, paying the winner's costs in taking over from the existing supplier (a private operator), discounting the transition costs for the purposes of comparing bids and paying the incumbent supplier to effect the transfer. This was all to encourage competition for the very large contract (approximately £3.8 billion). Compared to the total value of the ASPIRE contract the £75 million spent on costs of procurement and transition were small, about two per cent of the projected value of the contract.
- 5.18 In the National Audit Office's (NAO's) value for money report looking at the procurement, the transition and the initial performance of the contract, the NAO judged that HMRC was successful in completing the first major re-competition of a large public sector IT contract and that there was justification in this case for using incentives to encourage competition. The NAO also concluded that HMRC considered that not to pay these costs would send out a wider signal to the market that the department was effectively locked-in to the incumbent supplier because the costs of transition would make the competition unwinnable for any supplier other than the incumbent.³⁴
- 5.19 Chapter 6 outlines further ways in which competitive neutrality could be achieved.

³⁴ NAO, 2006, *HM Revenue & Customs: ASPIRE - the re-competition of outsourced IT services*. Available at: www.nao.org.uk/publications/0506/hm_revenue_and_customs_aspire.aspx

6 WHAT CAN WE DO TO ADDRESS THESE CONSTRAINTS?

6.1 There are a number of ways of achieving competitive neutrality. These include:

- Reviewing differences in regulation, tax, and pension between different types of operator.
- Ensuring that public procurement takes place on a competitively neutral basis. This may include improving existing guidance on procurement.
- Appropriate corporate governance for state-owned enterprises.
- Introducing overarching competitive neutrality principles or framework.

Current UK Government approach

6.2 Some UK Government departments have tried consciously to tackle the issue of competitive neutrality. The Ministry of Justice (MoJ) and Department for Work and Pensions (DWP) have taken a number of steps to try and ensure that procurement is carried out in an efficient manner. The Department of Health (DH) has also taken steps to try and ensure that competition between the NHS and private and third sector organisations operates fairly.

6.3 **The National Offender Management Service (NOMS):** the original remit of NOMS expressly stated that it intended to commission services from the best provider. In recent MoJ contracts for custodial services there were *Principles of competition* which set out ways in which competitive neutrality concerns would be addressed in the procurement process. More details are given in Box 3.

Box 3: Prisons

In November 2009 the Ministry of Justice announced a competition to operate custodial services at HMP Birmingham, HMP Buckley Hall, HMP & YOI

Doncaster and HMP Featherstone II. In addition a contract was announced to operate custodial services at HMP Wellingborough with the potential to upgrade the facilities at the prison. The competition for these contracts will be assessed in line with the *Principles of competition* (the Principles). These Principles were developed after consultation with stakeholders and designed to remove any advantages that apply to particular bidders as a result of their ownership. We now briefly outline the main Principles.

Process: The MoJ has separated its regulatory, commissioning, procurement and bidding functions into different departments to try to avoid any conflicts of interest that arise when assessing public, private and third sector bids. The MoJ also aims to provide all relevant information in a timely manner to try and reduce any incumbency advantages.

Costing: A formula is given which must be applied to all public sector bids to reflect the allocation of indirect costs. Transition, contract administration and monitoring costs will not be allocated to any bid unless they are additional costs arising because of a particularly novel approach in one bid.

Grant funding: All bidders must declare any grant funding, including any received by subcontractors. Bidders must attest that any grant will not be used to subsidise their bid, including indirect costs.

Pensions: Information is given about the Cabinet Office's Statement of Practice on Staff Transfers in the Public Sector (COSOP). COSOP addresses pensions and provides guidance on the broader issue of the treatment of staff who are transferred from the public sector. Where there is a public sector incumbent, all public sector bids must apply an uplift of three per cent per annum to all payroll costs.

Risk: A list of risks which are considered insurable is given and the principles require that each bid includes a limit of liability for each of the listed risks irrespective of bidder type. Any public sector bidder is required to obtain a quote for commercial insurance cover. Bidders must identify all other risks contingent on the contract and clearly attribute their true commercial value. These risks include: contractor performance, asset and property maintenance risks and pension costs and liabilities. If a part of the service does not meet the service

level stated in the contracts the contractor will incur a penalty, while a public sector bidder may not ultimately be subject to such financial deductions, their bid shall be evaluated as if these deductions were to apply.

Tax: Special mention is made of VAT and Corporation tax (CT) and the different liabilities faced by different bidders. The evaluation of bids will exclude VAT and CT although bidders are required to provide details of expected liabilities for both.

6.4 **The Department of Health's** 2007 commissioning framework is designed to promote 'a stronger focus on commissioning the services and interventions that will achieve better health, across health and local Government, with everyone working together to promote inclusion and tackle health inequalities.'³⁵ This framework is currently being rewritten. The NHS's *Principles and rules for cooperation and competition* document,³⁶ issued in December 2007, set out fair competition rules for primary care trusts to apply to all providers. Competitive neutrality is recognised in the principles which state that 'commissioners should commission services from the providers who are best placed to deliver the needs of their patients and population.'³⁷ In January 2009 the Cooperation and Competition Panel (CCP) was launched. The CCP helps ensure that the principles and rules are followed and investigates potential breaches.

6.5 **The Department for Work & Pensions** (DWP) uses a 'prime contractor' model where there is one main contractor who has direct contact with

³⁵ p 10, Department of Health, 2007, *Commissioning framework for health and well-being*.

Available at:

www.dh.gov.uk/en/publicationsandstatistics/publications/publicationspolicyandguidance/DH_072604

³⁶ NHS, 2007, *Principles and rules for cooperation and competition*. Available at:

www.ccpnl.org.uk/content/Principle-and-rules-for-Cooperation-and-Competition.pdf

³⁷ p 4, NHS, 2007, *Principles and rules for cooperation and competition*. Available at:

www.ccpnl.org.uk/content/Principle-and-rules-for-Cooperation-and-Competition.pdf

DWP and then subcontracts out various parts of the contract. The level of subcontracting differs between prime contractors. After consulting with potential providers from all sectors DWP published a Commissioning Strategy³⁸ in February 2008. While this Strategy does not have a distinct competitive neutrality section, it does describe best practice with regard to treatment of sub-contractors and other partners or suppliers, including recognition of third sector requirements, and gives principles of behaviour between providers.

- 6.6 As far as we are aware, there has so far been little work to evaluate whether these different competitive neutrality approaches have been successful in helping deliver better outcomes. There may be benefits in implementing measures to evaluate these.

Procurement guidance

- 6.7 Good procurement means getting value for money – that is, buying a product or service that is fit for purpose, taking account of the whole-life cost.
- 6.8 The Government has recognised how important good procurement is, and issued a range of guidance about how a successful tendering process can be run. For example, HM Treasury (HMT) has issued guidance about methods for running successful procurement processes, and the Office of Government Commerce (OGC) was established to help Government achieve value for money.
- 6.9 There are also some general principles which help deliver successful procurement in most cases.³⁹ These principles have been adopted by some central Government departments. For example the Communities

³⁸ DWP, 2008, *DWP Commissioning Strategy*. Available at: www.dwp.gov.uk/docs/cs-rep-08.pdf

³⁹ The principles are given in HM Treasury, 2007, *Transforming government procurement*. Available at: www.supply2.gov.uk/pdfs/transforming_government_procurement.pdf

and Local Government (CLG) *National Procurement Strategy for the Fire and Rescue Service 2008 – 2011* consultation paper incorporates the principles.⁴⁰

- 6.10 The third sector faces specific barriers to entry when it is considering bidding for public contracts. This is primarily due to their scale and lack of expertise in bidding for public contracts. To try and address these concerns in 1998 the 'Compact on Relations between Government and the Voluntary and Community Sector in England' ('the Compact') was introduced. This is a framework agreement for how the Government and the third sector should work together and is designed to improve the relationship between the two.⁴¹
- 6.11 Competitive neutrality during the procurement process is important to ensure the best outcome is achieved. The way procurement is managed can also have a substantial impact on competition in the market. This is examined in more detail in the OFT's *Assessing the impact of public sector procurement on competition*.⁴²

Corporate governance for publicly owned organisations

- 6.12 Another way of encouraging competitive neutrality is to have corporate governance measures which ensure that publicly owned bodies operate in a way that does not unnecessarily distort the market. In many cases

⁴⁰ Paragraph 2.3.26, CLG, 2008, *The National Procurement Strategy for the Fire and Rescue Service 2008 – 2011, Consultation*. Available at: www.communities.gov.uk/documents/fire/doc/procureconsult.doc

⁴¹ The national Compact is underpinned by codes of good practice on: funding and procurement, consultation and policy appraisal, ethnic minority voluntary and community organisations, volunteering and community groups. Local Compacts, informed by the national Compact and Codes, are local level agreements for partnership working between voluntary and community sector organisations and public sector bodies at the local level. See www.cabinetoffice.gov.uk/third_sector/compact.aspx for more information.

⁴² OFT, 2004, *Assessing the impact of public sector procurement on competition*. Available at: www.of.gov.uk/advice_and_resources/resource_base/market-studies/completed/procurement

publicly owned bodies are run at arms-length from the owner, for example municipally owned bus operators.⁴³

- 6.13 Having appropriate corporate governance measures in place is an important part of having an effective legal and regulatory framework for state owned enterprises. The OECD has issued guidelines on the corporate governance of state owned enterprises. The importance of competitive neutrality is noted in the Foreword as follows: 'another important challenge is to ensure that there is a level-playing field in markets where private sector companies can compete with state-owned enterprises and that Governments do not distort competition in the way they use their regulatory or supervisory powers.'⁴⁴

UK

- 6.14 The UK has a number of bodies that are designed to manage the Government's involvement in businesses.
- 6.15 The Shareholder Executive⁴⁵ manages the Government's shareholding in UK businesses. The Government currently owns shares in 29 businesses in varying proportions of total ownership. The Shareholder Executive's overarching objective is to be an effective shareholder of businesses owned or part-owned by the Government. It has a number of specific objectives relating to the businesses it has an interest in.
- 6.16 Since the banking crisis in 2008 caused the Government to take stakes in a number of banks, UK Financial Investments (UKFI)⁴⁶ has managed

⁴³ The 1985 Transport Act required municipal and passenger transport executive (PTE) operators to be run at arms-length from the local authority
cfit.independent.gov.uk/pubs/2001/ebp/ebp/stage3/a1.htm

⁴⁴ OECD, 2005, *OECD Guidelines on Corporate Governance of State-Owned Enterprises*. Available at: www.oecd.org/dataoecd/46/51/34803211.pdf

⁴⁵ www.shareholderexecutive.gov.uk

⁴⁶ www.ukfi.gov.uk

those shares. UKFI is a Companies Act Company with HM Treasury as its sole shareholder. The company's activities are governed by its Board, which is accountable to the Chancellor of the Exchequer and, through the Chancellor, to Parliament. UKFI's objective is set out on its website as being 'to protect and create value for the taxpayer as shareholder with due regard to the maintenance of financial stability and to act in a way that promotes competition.'⁴⁷

6.17 Partnerships UK (PUK)⁴⁸ is a public private partnership (PPP)⁴⁹ between HMT and the private sector which works with the public sector in five main areas.

- supporting complex procurement projects
- developing procurement and investment policies
- supporting individual infrastructure projects
- developing public service commissioning models
- investing in projects and companies

6.18 Part of this work involves PUK supporting the market through the production of guidance and standard forms and governance and regulatory support through various review processes.

⁴⁷ www.ukfi.gov.uk/about-us/what-we-do/

⁴⁸ www.partnershipsuk.org.uk

⁴⁹ A PPP is an umbrella term for Government schemes involving the private sector in public sector projects.

