

Completing competition assessments in impact assessments

Draft guideline for policy makers

February 2007

OFT876con

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INTRODUCTION TO THE CONSULTATION

In addition to the OFT's competition enforcement functions, under the Enterprise Act 2002 we seek to influence government policy in order to ensure markets work well for consumers. This includes competition scrutiny of Impact Assessments (IAs), previously known as Regulatory Impact Assessments (RIAs). The OFT has provided advice and training to other government departments on competition assessments in IAs since 2003.

Last year, we reviewed the effectiveness of the competition assessment. We concluded that it was too heavily focused on market structure and market shares, rather than on identifying the likely impacts on competition. Consequently, the OFT has redesigned the competition assessment and redrafted the guidelines, so that they focus more on the likely effects on competition of proposed regulations.

THE CONSULTATION PROCESS

Responding to this consultation

We are inviting comments on the draft guideline. The aim of this consultation is to produce a guideline which is clear, comprehensible and covers all relevant matters. We would therefore like to know if the draft meets this aim and, if not, how you believe we can improve the document. This includes identifying omissions and, as the case may be, unnecessary content, as well as suggestions for making the current content as clear, easy to read and accurate as it can be.

List of questions

Q1 Is the draft guideline sufficiently clear?

Q2 Are there any substantive aspects of the guideline with which you disagree?

Q3 Does the guideline have any significant omissions?

Q4 Do you have any other suggestions for improvement to the guideline?

Q5 Do you have any views on how the final guideline should be disseminated to those who may need to see it?

We are happy to take comments and suggestions for improvement which fall outside the list of questions where you believe these will help produce a better final document.

We welcome comments on this guideline document from all sources. Consultees responding to this consultation are asked to supply a brief summary of the interests or organisations they represent, where appropriate.

We ask that any suggested changes or comments on the documents be submitted in writing (by email, or alternatively by letter or fax, as indicated below).

The consultation period

The consultation period began on 19 February 2007 and will run until 18 May 2007. This period of 12 weeks is in accordance with the criteria set out in the Cabinet Office's Code of Practice.

Next steps

All responses and comments should be sent to:

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After the consultation, we will publish the final version of the guideline taking into account the comments received.

Data use statement for responses

Please note that we may choose to refer to comments received in response to this consultation in future publications. In deciding whether to do so, we will have regard to the need for excluding from publication, as far as that is practicable, any information relating to the private affairs of an individual or any commercial information relating to a business which, if published, would

or might, in our opinion, significantly harm the individual's interests, or, as the case may be, the legitimate business interests of that business ('confidential information'). If you consider that your response contains such information, that information should be marked 'confidential information' and an explanation given as to why you consider it is confidential. All information received is subject to Part 9 of the Enterprise Act 2002.

If you are replying by email, these provisions override any standard confidentiality disclaimer that is generated by your organisation's IT system.

CONTENTS

<i>Chapter</i>	<i>Page</i>
Introduction to the consultation	
1 Purpose and scope of this guideline	3
2 The competition assessment	6
3 The process	8
4 Identifying the impact of a regulation on competition	9
5 Direct limits on the number or range of suppliers	17
6 Indirect limits on the number or range of suppliers	21
7 Limits on the ability of suppliers to compete	23
8 Limits on suppliers' incentives to compete vigorously	27
9 Further information	30

1 PURPOSE AND SCOPE OF THIS GUIDELINE

The Office of Fair Trading

- 1.1 The Office of Fair Trading is a non-ministerial government department. The OFT's stated mission is to make markets work well for consumers and, as such, it has a role in making proposals or giving information and advice to Ministers and their departments in respect of any aspects of the law or proposed changes in the law.¹
- 1.2 The OFT provides advice and training, on request, to policy makers and economists who are involved in completing the mandatory competition assessment in impact assessments.
- 1.3 The OFT is willing to provide assistance to policy makers at any stage in the process but recommends that advice is sought at an early stage. The OFT endeavours to be pragmatic in its approach, accepting that in some cases, the proposal may be intended to meet public policy objectives and competition may be adversely affected.

Assessing the impact of regulation

- 1.4 Impact Assessments (IAs) require policy makers to consider the impact – the costs and benefits – of proposed policies. Through consultation and the IA, policy makers will set out the effect of the policy proposal and the justifications underlying it.
- 1.5 The competition assessment focuses on the impact of the proposed policy on competition in affected markets, assessing whether or not the policy is likely to have a significant impact on competition.
- 1.6 To assess the direct and indirect effects of the proposed regulation on competition, affected markets need first to be identified. This guideline

¹ Section 7(1), Enterprise Act 2002.

provides policy makers and economists with assistance in identifying markets and in undertaking the competition assessment.

1.7 This guideline:

- sets out the four questions of the competition assessment, together with examples to assist policy makers and economists in considering those questions (chapter 2)
- explains the process by which policy makers and economists should undertake the competition assessment (chapter 3)
- provides broad guidance to policy makers in identifying affected markets (chapter 4)
- explains why direct (chapter 5) and indirect (chapter 6) limits on the number or range of suppliers might raise competition concerns
- explains why policies that limit the ability of suppliers to compete (chapter 7) or reduce suppliers' incentives to compete (chapter 8) raise competition concerns
- provides information on sources and guidance on further information (chapter 9).

1.8 This guideline replaces an earlier guideline drafted in 2002.

1.9 This guideline is written for policy makers and does not therefore assume any technical knowledge or understanding of economics. However, the OFT recommends that at an early stage in the process policy makers advise their departmental economists that they are considering the effect of the proposed policy on competition. Indeed, the OFT notes that the National Audit Office's (NAO) last report states that 'Government intervention leads to changes in markets and departments

therefore need to engage with specialists who can help to analyse these impacts. For example, the OFT'.²

Contact the OFT

- 1.10 Policy makers and economists who wish to speak to the OFT about undertaking competition assessments in IAs or who wants to request further explanation of this document or training, should call the 'hot line' telephone number – (020) 7211 8500 – or send an email to the mailbox – competitionassessment@oft.gsi.gov.uk

² *National Audit Office – Evaluation of Regulatory Impact Assessments 2005-06.*

2 THE COMPETITION ASSESSMENT

- 2.1 Policy makers completing the IA one page summary are required to consider if the proposal will have a significant impact on competition.
- 2.2 Policy makers should answer this question by considering the four questions posed in the competition assessment, which are accompanied by examples of instances where competition might be adversely affected.

In any affected market, would the proposal:

1. Directly limit the number or range of suppliers?

This is likely to be the case if the proposal involves:

- the award of exclusive rights to supply
- procurement from a single supplier or restricted group of suppliers
- the creation of a form of licensing scheme
- a fixed limit (quota) on the number of suppliers

2. Indirectly limit the number or range of suppliers?

This is likely to be the case if the proposal significantly raises the costs:

- of new suppliers relative to existing suppliers
- of some existing suppliers relative to others
- of entering or exiting an affected market

3. Limit the ability of suppliers to compete?

This is likely to be the case if the proposal:

- controls or substantially influences
 - the price(s) a supplier may charge
 - the characteristics of the product(s) supplied, for example by setting minimum quality standards
- limits the scope for innovation to introduce new products or supply existing products in new ways
- limits the sales channels a supplier can use, or the geographic area in which a supplier can operate
- substantially restricts the ability of suppliers to advertise their products
- limits the suppliers' freedoms to organise their own production processes or their choice of organisational form

4. Reduce suppliers' incentives to compete vigorously?

This may be the case where a proposal:

- exempts suppliers from general competition law
- requires or encourages the exchange between suppliers, or publication, of information on prices, costs, sales or outputs
- increases the costs to customers of switching between suppliers

3 THE PROCESS

- 3.1 The competition assessment is set out in chapter 2 of this document. It consists of four questions, accompanied by a number of illustrative examples to assist policy makers in assessing the impact of the proposed regulation on markets affected by it.
- 3.2 Before beginning the consultation process, policy makers will need to identify who, directly or indirectly, will be affected by the proposed policy. The same information provides a starting point for the competition assessment which requires policy makers to identify the directly affected (product) markets as well as other markets in the supply chain which may also be affected. Where the supply chain is not fully understood, policy makers should attempt to clarify it through the consultation process.
- 3.3 Guidance on how to identify markets is given in chapter 4.

Policies that raise no competition concerns

- 3.4 Where the answers to all questions in the competition assessment are 'no', the proposed policy is unlikely to raise any competition concerns. A short statement explaining why this is the case should be included in the supporting documentation to the one page summary.

Policies that raise competition concerns

- 3.5 Policy makers answering 'yes' to any question in the competition assessment will need to explain the effect of the proposal in the supporting documentation of the one page summary. The level and detail of the analysis should be proportionate to the likely effect on competition. Where possible, policy officials should attempt to quantify the costs and benefits of the impact on competition.

4 IDENTIFYING THE IMPACT OF A REGULATION ON COMPETITION

- 4.1 The OFT views competition as a process of rivalry between firms seeking to win customers' business. This process of rivalry, where it is effective, impels firms to deliver benefits to customers in terms of prices, quality and choice. Where levels of rivalry are reduced (say because a regulation restricts the number of firms active in any market) customers have less choice because they have fewer firms among whom they can buy goods or services.
- 4.2 Competition between firms may focus on offering the lowest price, particularly where the product is standardised (either because of the characteristics of the product in question, or because of regulation). Most suppliers will try and compete in a number of ways in addition to price, for example by developing new 'improved' products, by offering products of differing quality or characteristics, by branding and advertising the differences in their products relative to their competitors', or by using different sales channels. This list is not exclusive: successful suppliers will seek to find a unique selling point by which their product stands out from that of their rivals'.
- 4.3 Policy makers should be aware that regulations can have a substantial effect on competition.

Identifying the purpose of the policy or regulation

- 4.4 The IA requires policy makers to set out the purpose of the proposed policy or regulation. This requires policy makers to think about why government intervention is necessary.
- 4.5 In many cases, the government decides to intervene where there is a desire to improve the working of a particular market, perhaps because there are concerns over the market outcomes for consumers of the product or service (so-called 'market failures'). Frequently these concerns relate to product safety standards, to the insufficient provision of goods beneficial to the public ('public' or 'merit' goods), to insufficient

or incomplete information that prevent customers from making rational decisions, or to social objectives such as imposing certain conditions on workers to improve their conditions of work.

- 4.6 Policy makers need to understand who, directly or indirectly, is affected by the proposed policy. In many cases, this identification is straightforward but in some cases, policy makers may need to use the consultation process to identify who is affected by their proposals.

The counterfactual

- 4.7 Regulations are often introduced because of market failure. The competition assessment assists policy makers in assessing the impact of a proposed regulation. Policy makers should be aware that regulatory failure may impose higher costs than the market failure the regulation is designed to correct.

- 4.8 Policy makers need to identify the markets affected by the proposed regulation before they can assess the impact on competition.

- 4.9 An initial assessment of the current state of competition (the counterfactual) in those markets is required before the effect of the regulatory proposal can be assessed.

- 4.10 To identify the counterfactual, policy makers should collate information on:

- the characteristics and prices of products (and services) affected by the proposed regulation
- the ease with which customers can switch between competing products (and services) and the degree of customer switching
- the number and locations of suppliers in the affected market(s)
- the degree of invention and innovation in recent years

- the ease or difficulty with which new suppliers can enter the market (and the history of recent entry)
- the nature of competition
- competition between relatively standardised products may be focused on price, or
- competition may be focused on product diversity and differentiation.

4.11 The OFT competition law guideline³ provides more information about how to assess the current state of competition.

What is a market?

4.12 In most cases, a market generally consists of a group of similar products sold in a particular area. The OFT has considerable expertise in defining 'relevant markets' because this is an important step in assessing competition effects.

4.13 The OFT generally takes account of the relevant product market and the relevant geographic market in defining the relevant market or markets.⁴ The starting point for identifying the market or markets affected by any policy is to identify the products or services directly affected. This is generally straightforward.

4.14 Once directly affected markets have been identified, consideration should be given to those products or services that may be indirectly affected by the policy because consumers or suppliers would substitute to other products in response to the new policy.

4.15 In assessing the indirect effects, consideration should be given to:

³ *Assessment of market power.*

⁴ The OFT has published guideline on *Market definition.*

- the willingness and ability of consumers to switch from buying the product (or service) affected by the policy to alternative products (or services) not so affected, and
 - the willingness and ability of suppliers to switch to supplying alternative products (or services) to those affected by the policy.
- 4.16 A hypothetical example serves to illustrate these impacts: A new regulation that required that all towels used in a hair-dressing salon must be laundered professionally would obviously affect hair-dressing salons.
- 4.17 The regulation would raise hairdressers' costs directly. Hairdressers would likely respond by raising their prices. Consumers, faced with higher prices in hairdressers' salons, may choose to have their hair cut elsewhere where the regulation did not apply and there was no increase in price. Hairdressers themselves may respond by offering to cut hair at customers' homes or in any other location than a salon.
- 4.18 Extending the hypothetical example, the restriction on hairdressers requiring them to launder towels professionally may be introduced only in Wales. Customers living near the English border could switch to having their hair cut in England to circumvent the effect of the regulation (and higher prices in Wales).
- 4.19 In determining the effect of the policy, the geographic dimension of the market must also be defined. Markets may be local, regional, national or international. While policies may be limited in their jurisdiction they may have wider effects because of the ability of consumers and suppliers to purchase or supply in a broader geographic area.
- 4.20 The width of the geographic market will depend on the product or service being supplied. In some cases, a policy may have differing effects in different geographic markets because of the difference in the ability and willingness of customers and suppliers to switch to competing products or services.

Related markets

- 4.21 When identifying affected markets it is important to consider whether or not there will be knock-on effects in related markets. In making this assessment, policy makers should identify the supply chain for the product or service affected by the proposed policy and the impact of that proposed regulation on the supply chain.
- 4.22 Policy makers will need to consider the effect of their proposals on suppliers of inputs required to produce the affected products. This requires a reasonable understanding of the production process – where policy makers do not have this information, they should use the consultation process to gather it.
- 4.23 Policy makers will also need to consider whether their proposals affect those who distribute, wholesale or retail the affected products. The assessment of these wider market effects depends on acquiring a good understanding of the supply chain.
- 4.24 A hypothetical example serves to illustrate these impacts: Suppose there were concern about stray dogs, and policy makers were keen to introduce a regulation that would require all dogs to be fitted with microchip identification tags. Policy makers consider it appropriate that these are inserted by veterinary surgeons but have been advised that it would be sensible to allow pet shop owners who have received the relevant training to fit microchips into dogs.
- 4.25 This proposed regulation would have a direct impact on the market for dogs. Veterinarians and pet-shop owners would need to undertake training, acquire equipment and fit tags in dogs. The cost of this would be borne by dog owners. (One unanticipated effect that may occur is that dog owners unwilling to pay for tags to be fitted in their pets may abandon them to avoid the regulation.) This may lead potential dog owners to switch to owning other pets not caught by the regulation.

4.26 Related upstream markets affected by this proposal include:

- UK trainers able to provide training to veterinary surgeons and pet shop owners
- UK/ overseas manufacturers, wholesalers, and retailers of microchips
- UK/ overseas manufacturers, wholesalers, and retailers of microchip scanners.

4.27 If the hypothetical proposal were mandatory, policy makers would have to check with these parties whether or not they would be able to supply sufficient microchips, training and scanners to meet demand for these inputs. These parties may also be able to provide information on the cost of the inputs and the level of current demand, as well as their estimates of the impact of the regulation on prices, which would allow policy makers to estimate the cost of the proposed regulation.

Evaluation of the proposed regulation

4.28 Once the policy maker has identified the markets affected by the proposed regulation, and the existing state of competition in those markets (the counterfactual), s/he can consider the impact of the proposed regulation by reference to the four questions of the competition assessment.

4.29 The four questions are designed to focus on the effect of the proposed regulation on competitive pressures and the incentives of suppliers. Where there is a significant detrimental effect, policy makers should consider whether or not there are suitable alternatives to the proposed regulation that limit restrictions on competition whilst still achieving policy objectives.

Alternatives to regulation

4.30 Assessing the effect of each option on competition in affected markets allows policy makers to pre-empt problems that may arise, as well as reducing the potential for unanticipated effects.

- 4.31 Where a proposed regulation is likely to adversely affect competition in an affected market, policy makers should consider whether there are alternative proposals that will achieve the same policy objective but with less adverse effects.
- 4.32 In some cases, market failures can be remedied through non-regulatory alternatives:
- doing nothing
 - incentives (tax/ subsidy)
 - information and education campaigns
 - self regulation (trade associations)
 - co-regulation (recognised and enforced by government).⁵

Subsidies

- 4.33 Subsidies can distort competition between firms undertaking similar activities, particularly when subsidies are large and only available to a selection of the firms that compete with each other. The OFT's *Guidance on how to assess the competition effects of subsidies* explains how impacts on competition can be taken into account when a government department or agency undertakes an appraisal of a subsidy, according to the Treasury's *Green book* or guidance based on the Green book.
- 4.34 It should be noted that almost all UK subsidies are state aid, and therefore need to comply with the European State Aid rules. These rules place legal obligations on Member States which must be adhered to regardless of the application of the OFT guidance.

⁵ More detail on these can be found in the Better Regulation Task Force leaflet - *Alternatives to Regulation*.

Implementation Issues

- 4.35 Policy makers should also consider the means by which the regulation is implemented to ensure that they are consistent with the intention of the proposed regulation since it is often the case that the implementation of a regulation creates competition issues that were not foreseen at the consultation or early stage of IA. For example, it may be decided at the implementation stage that a limited number of suppliers can bid to supply the product under consideration – at the consultation stage it was envisaged that there would be no such limit so the competition issues arising from imposing a limit on the number of suppliers were not considered.
- 4.36 Where policy makers use the consultation process to check data and information about the market(s) affected by their proposals, they should remain aware that views expressed, or data or information supplied, may be selective and could well reflect vested interests.

5 DIRECT LIMITS ON THE NUMBER OR RANGE OF SUPPLIERS

- 5.1 The threat of entry is a powerful competitive constraint on existing firms in a market. Entry often allows new business ideas to be brought to market and tested. Firms may choose to enter a market by developing new products, cheaper production methods and/or alternative sales channels and these ensure customers benefit from increased choice as well as ensuring that existing firms set prices at competitive levels. Successful entry may result in more intensive competition which may serve to increase sales overall, or it may displace less efficient suppliers (who exit the market in the face of falling sales).
- 5.2 Entry may occur because new suppliers develop new products or services or because they increase their geographic reach, or it may occur because existing suppliers (of related products) want to diversify their product range or develop new services.
- 5.3 Entry, or the threat of entry, is an important competitive pressure on existing suppliers. Policies that directly prevent entry are likely to reduce the competitive pressures faced by existing suppliers, with potential adverse effects on prices and/ or quality of products or service.
- 5.4 The competition assessment poses the question whether the proposal might directly limit the number or range of suppliers, for example through:
- the award of exclusive rights to supply
 - procurement from a single supplier or a restricted group of suppliers
 - the creation of a form of licensing scheme
 - a fixed limit on the number of suppliers.

Exclusive rights to supply

- 5.5 The regulations governing the National Lottery created, deliberately, an exclusive right to supply a product/ service.
- 5.6 The National Lottery is protected, through these regulations, from competitive pressure, which may result in lower quality services and a higher price to consumers. (In the case of the National Lottery, the government created a regulator to protect consumers.)
- 5.7 The contract for the National Lottery was awarded as a result of a competitive process – an example of 'competition for the market'. Bidding markets are often used in situations where it is known that there will be no competition in the market, and thus no competitive pressure, to ensure that potential suppliers face competitive pressures in bidding for the contracts on offer.
- 5.8 Policy makers considering policies that will create exclusive rights to supply should consider whether there is sufficient justification for an outcome that restricts competition in the market. While competition for the market introduces some competitive constraints, it may be less effective than competition in the market, particularly in situations where some bidders may be in an advantageous position relative to others because of their previous experience or other factors relevant to the bidding process.
- 5.9 Policy makers considering the introduction of policies that would grant exclusive rights should ensure that the contracts are of relatively short duration to allow for regular competition for the exclusive rights.

Procurement from a single supplier or a restricted group of suppliers

- 5.10 Where a proposal would lead to a single supplier gaining the contract, and the single supplier is (as in many public sector contracts) the sole

purchaser in the market, the procurement process is akin to the award of an exclusive right to supply and the same competition issues apply.

- 5.11 Policy makers may consider that there are clear benefits (resulting from efficiencies in the procurement administration and lower costs because of bidding competition) from awarding a single contract but they should be aware that these benefits should be weighed against the loss of competition and choice.
- 5.12 The size of the contract on offer may limit the number of firms able to bid, and this may itself restrict the number of potential suppliers. Frequently in large contracts, sub-contracts are let to smaller suppliers and it may be possible for the policy maker to think through these options to ensure there is sufficient competition for the market.
- 5.13 Economists advising on policies relating to public procurement are advised to read the OFT report which provides advice on design issues.⁶

The creation of a form of licensing scheme

- 5.14 Licensing is frequently used as a means of ensuring suppliers have achieved a minimum level of competency or are otherwise fit to operate in a particular market. In some progressions, only persons holding certain qualifications are allowed to work in that profession – restrictions such as this are a form of licensing.
- 5.15 In some markets, such as the taxi industry, the number of licences offered in a particular area may be fixed. Fixing the number of licences on offer creates an absolute barrier to entry and protects existing licensees from the competitive process. In other markets, there may be a requirement to meet certain qualifications and a restriction on the number of people who can qualify to work in that market.
- 5.16 Many licensing schemes are self-funding. The cost of entry is directly linked to the licence fee or to changes in the entry requirements – the

⁶ *Assessing the impact of public sector procurement on competition.*

cost of new entry should be considered against the revenues that a new entrant could expect to receive.

- 5.17 For a licensing regime to be effective, it must be monitored and enforced effectively. The incentives to comply with the licensing regime should also outweigh the incentives for non-compliance. Otherwise, unlicensed firms will continue to operate in competition with licensed firms and this might destabilise the licensing regime itself.
- 5.18 Economists advising on policies relating to licensing schemes are advised to contact the OFT for advice on the design and operation of the proposed regime.

A fixed limit on the number of suppliers

- 5.19 The OFT is aware, through its market studies of private dentistry, pharmacies and taxis, that policy makers may be persuaded that there is a limit on the number of firms that can operate effectively in any market. As a result, policy makers may grant existing suppliers rights to veto new entry – protecting them from competitive pressure but harming consumers faced with less competition and choice.

6 INDIRECT LIMITS ON THE NUMBER OR RANGE OF SUPPLIERS

- 6.1 In addition to directly restricting the number of suppliers, regulatory proposals can indirectly restrict the number of suppliers, primarily through their impact on suppliers' costs. Where the impact on costs is small and affects all suppliers equally, there is likely to be little effect on competition. Where the cost is significant, suppliers may choose to exit the market since their profitability may be adversely affected.
- 6.2 The competition assessment asks whether the proposals indirectly limit the number or range of suppliers, for example where a policy:
- significantly raises the costs of new suppliers relative to existing suppliers
 - significantly raises the costs of some existing suppliers relative to other existing suppliers
 - significantly raises the costs of entering, or exiting, the affected market.

Significantly raises the costs of new suppliers relative to existing suppliers

- 6.3 Existing suppliers can often persuade policy makers to exempt them from the impact of new policies, at least for a time. This exemption, even if temporary, may deter new entrants who face higher costs in complying with the policy.
- 6.4 In other cases, when faced with scarce inputs, such as airport landing slots and radio spectrum, existing suppliers may argue that they should be given preferential access ('grandfather rights') or preferential rates for these inputs than new entrants to the market.

- 6.5 In both these cases, new suppliers face higher costs than existing suppliers and may be deterred from entering the market as a result.

Significantly raises the costs of some existing suppliers relative to other existing suppliers

- 6.6 Policies may, deliberately or inadvertently, favour some suppliers over others. For example, a policy that imposes new technology on firms will favour new entrants who have already adopted this technology. A policy that specifies a product standard may favour suppliers already meeting that standard over others that are not.

Significantly raises the costs of entering or exiting from and affected market

- 6.7 Policies raising the cost of entry will deter entry. The costs must be compared with the likely revenues of firms to assess their deterrent effect. Policy makers should also consider whether the new firm is able to pass on its increased costs or whether they will directly affect the profitability of the firm.
- 6.8 Policies may raise the costs of firms wanting to exit the market and this may itself deter new entry. For example, stringent regulations requiring the clean-up of industrial factories may deter new entrants from leasing this space (which might otherwise have been affordable enough to allow entry).

7 LIMITS ON THE ABILITY OF SUPPLIERS TO COMPETE

7.1 Competition between suppliers may focus on price, quality, service or innovation. Policies that restrict the means by which suppliers compete with each other can inhibit competition between those suppliers. Regulations may constrain innovative suppliers from developing new product characteristics, new advertising and marketing initiatives, or alternative sales channels.

7.2 The competition assessment asks whether proposals limit the ability of suppliers to compete, for example where a policy:

- controls or substantially influences
 - the price(s) a supplier may charge
 - the characteristics of the product(s) supplied, for example by setting minimum quality standards
- limits the scope for innovation to introduce new products or supply existing products in new ways
- limits the sales channels a supplier can use, or the geographic area a supplier may supply in
- substantially restricts the ability of suppliers to advertise their products
- limits the suppliers' freedoms to organise their own production processes or their choice of organisational form.

Controls or substantially influences the price(s) a supplier may charge

7.3 Concern about price may result in a policy that sets minimum or maximum prices (price floors or ceilings) for particular products or services. The policy objective may protect consumers but there may be significant adverse effects on competition.

- 7.4 Minimum prices (price floors) have sometimes been proposed to ensure that certain quality or safety standards are maintained, in the interests of consumers. However their effect is to protect existing producers from the competitive process. In the absence of a price floor, more efficient producers would undercut their rivals and consumers would benefit from lower prices. Inefficient producers would need to find more efficient means of production to remain in the market. If the policy objective was to raise product quality, direct regulation of product quality might be a less restrictive means of delivery.
- 7.5 Maximum prices (price ceilings) may act as a focal point for suppliers, with prices drawn to the ceiling, reducing the intensity of price competition between suppliers. Price ceilings may be intended to protect consumers from producers with market power but there may be less restrictive means of delivering this objective. The imposition of a maximum prices may also lead to some suppliers exiting the market, may distort the choice of products supplied and may lead to the imposition of hidden charges to circumvent the price ceiling.

Controls or substantially influences the characteristics of the product(s) supplied, for example by setting minimum quality standards

- 7.6 Policies may be introduced to safeguard consumers from products that are of poor quality or that can be supplied into the market. The justification for this may be that consumers are unable to monitor the quality of products and may suffer harm as a result. Where safety is not an issue, such policies will restrict the ability of suppliers to compete with each by differentiating their products, and may prevent informed consumers from purchasing a lower quality, low cost product. For example, a policy requiring all airlines to provide all passengers with a hot meal on short-haul flights would require 'no-frills' airlines to offer customers hot meals when those customers may prefer a cheaper flight with no hot meal.

- 7.7 Seller reputation can safeguard quality, particularly where consumers can observe quality and make repeat purchases. Ensuring quality through performance-based standards is preferable to prescriptive standards since suppliers are able to tailor their products to that standard and there may be more choice for consumers. For example, pollution controls on car emission limits are preferable to restrictions on engine capacity limits since they will introduce incentives on producers to develop technology that minimises pollution.
- 7.8 Information about product quality and safety ensures that consumers are more aware and can make informed decisions at the time of purchase. Requirements to include certain information on labels provide consumers with more information about the competing products on offer.

Limits the scope for innovation to introduce new products or supply existing products in new ways

- 7.9 The development of new products is a key way in which suppliers compete to attract consumers. Regulations that limit the scope for innovation, for example, through restrictions on the characteristics of products that can be supplied, can restrict the intensity of competition between existing suppliers and with new suppliers. Restrictions on the production process used or means of supply can also limit the ability to innovate and limit competition.

Limits the sales channels a supplier can use, or the geographic area in which a supplier can operate

- 7.10 Certain medicines can only be sold in pharmacies. The regulation underlying this is intended to ensure that consumers are protected because a qualified pharmacist is available when the product is supplied. The regulation restricts the number of outlets from which consumers can purchase the medicine and therefore restricts competition and consumer choice. Geographic restrictions would have a similar effect.

Substantially restricts the ability of suppliers to advertise their products

- 7.11 Advertising provides an important means by which suppliers make known their product and by which they differentiate their product from those of their rivals. Restrictions on advertising may limit competition, particularly if they deter new entrants unable to make consumers aware of their new products. Advertising restrictions may be imposed to reduce demand for products that harm consumers but consideration should be given to the effect on competition.
- 7.12 Restrictions on misleading advertising are generally pro-competitive in that they ensure suppliers compete on equal terms and that consumers are protected from false claims.

Imposes restrictions on any supplier's production processes, or the choice of organisational form

- 7.13 Policies that restrict the production process may have social objectives such as the protection of employees. Such policies may limit the freedom of producers to be inventive and innovative and, as a result, producers may not become less efficient with adverse effects either on product quality or the prices paid by consumers.
- 7.14 Policy may prevent certain professionals (such as accountants) from organising themselves as public limited companies, requiring them to be organised as partnerships. Policy may restrict certain professionals from forming partnership with other qualified professionals. These types of policy limit the freedom of professionals to develop their services in innovative ways, and inhibit competition between them.

8 LIMITS ON SUPPLIERS' INCENTIVES TO COMPETE VIGOROUSLY

- 8.1 The essence of competition is that suppliers compete against each other, by offering lower prices, better service, or better quality products to win customers and market share. Occasionally suppliers may decide, implicitly or explicitly, not to compete with each other. Where competition has previously focused on price, suppliers may agree a common price (or range of prices) for goods or decide not to undercut each other. Alternatively, suppliers may agree not to compete in respect of certain customers or certain products, or to agree terms that make it difficult for customers to switch to competing suppliers.
- 8.2 The competition assessment asks whether proposals reduce suppliers' incentives to compete vigorously, for example where a policy:
- exempts suppliers from general competition law
 - requires or encourages the exchange between suppliers, or publication, of information on prices, costs, sales or outputs
 - increases the costs to customers of switching between supplier

Exempts suppliers from general competition law

- 8.3 European and UK competition laws prohibit anti-competitive agreements between undertakings, and prohibit dominant undertakings from abusing their market power.⁷
- 8.4 In assessing whether or not there has been a breach of EC competition law, the OFT (and the European Commission) would take account of the legislation and regulations faced by firms active in the relevant markets.

⁷ For further details refer to the OFT guidelines on *Agreements and concerted practices*, *Assessment of market power* and *Abuse of a dominant position*.

- 8.5 For example, Italian national legislation created a professional body for match manufacturers, who in turn established production quotas. As noted elsewhere, quotas may limit the incentives on suppliers to compete with each other. The European Court of Justice ruled that this legislation infringed the Treaty and that the national competition authority had a duty to disapply national legislation that requires or facilitates anti-competitive conduct that infringes Article 81(1) EC Treaty.⁸
- 8.6 Policy makers should seek advice from the OFT if they are concerned about this issue.

Requires or encourages the exchange between suppliers, or publication, of information on prices, costs, sales or outputs

- 8.7 Suppliers may use information on prices, costs, sales or outputs to coordinate behaviour amongst themselves to the detriment of consumers. This is more likely if there are few suppliers in the market, the product is relatively standardised, and entry barriers are high.
- 8.8 In some markets, particularly where the product or service on offer is highly differentiated between suppliers (for example, mobile telephone contracts) customers may find it difficult or costly to compare prices. This difficulty may be resolved by a policy requiring the publication of prices, reducing search costs and making it easier for consumers to compare alternative offers. The pro-competitive effect of this policy needs to be weighed against the possible anti-competitive effects.

⁸ *Consorzio Industrie Fiammiferi (CIF) V Autorita Garante della Concorrenza e del Mercato* [2003] 5 C.M.L.R. 16

- 8.9 Requiring suppliers to publish prices achieved may facilitate coordination since it allows competing suppliers to know what prices their competitors received for goods or services. The publication of these prices may lead suppliers to raise their prices to those achieved by others. For example, in 1993 the Danish competition authority published prices achieved by concrete suppliers, resulting in an increase in the overall price of concrete and a convergence in suppliers' prices.
- 8.10 Some seemingly harmless information may dampen competition. Publication of market share information, or capacity utilisation information, may give suppliers an insight into the competitive constraints faced by their rivals.

Increases the costs to customers of switching between suppliers

- 8.11 Customers faced with higher prices, poorer service or lower quality goods by their existing supplier will consider whether other suppliers offer a better deal. The ability (and willingness) of suppliers to switch between competing suppliers provides a key competitive constraint on firms.
- 8.12 Policies can be pro-competitive and encourage switching. For example, regulations introduced by OFTEL in relation to phone number portability ensured that customers were able to switch suppliers more easily and this provided a boost to competition in affected markets.
- 8.13 Contractual restrictions may inhibit switching – a policy or regulation that imposed a minimum contract period, or a minimum notice period for leaving the contract, on customers would find it more difficult to leave their existing supplier and suppliers would be less likely to compete vigorously for new customers.

9 FURTHER INFORMATION

9.1 Policy makers can talk to the OFT. Please contact the OFT's Regulatory Review Team - email: competitionassessment@oft.gsi.gov.uk or on (020) 7211 8500.

9.2 The OFT publishes a number of documents that may be useful to policy makers and economists:

- *Abuse of a dominant position*
- *Agreements and concerted practices*
- *Assessment of market power*
- *Assessing the impact of public sector procurement on competition*
- *Market Definition*
- *Guidance on how to assess the competition effects of subsidies*

9.3 Other documents that may be useful are:

- Better Regulation Task Force leaflet - *Alternatives to regulation*
- National Audit Office – *Evaluation of regulatory impact assessments 2005-06*
- European Commission – *Better Regulation: A guide to competition screening*
- Treasury - *Green book*

9.4 The OECD is planning to publish a comprehensive guide for policy makers completing competition assessments.

9.5 Websites that may be useful are:

- Better Regulation Executive homepage