

House of Lords Select Committee: inquiry into role of economic regulators

Evidence submitted by the Office of Fair Trading

1 June 2007

1. The submission provides evidence towards the following questions:

Q2: Where regulators have promoted competition, is it possible to quantify the benefits of competition, such as lower prices and improved standards of service? Where competition is not feasible have regulators nevertheless been able to reduce prices and/or improve service standards compared with what would have occurred otherwise?

Q6: Can the continued existence of economic regulators be justified on the grounds that the continuing benefits they provide exceed the costs they incur in their own operations and the costs they impose on the businesses they regulate?

Q7: What can be done to increase the benefits and reduce the costs of economic regulation?

SUMMARY

2. The following outlines OFT's recent efforts in quantifying the benefits of its activities to promote competition. Efforts in measuring benefits include in-depth ex-post evaluations of discrete projects, research on OFT's wider impact, and in-house work on estimating the impact of key activities. In most cases, together with evidence of OFT's impact we also report information on the costs incurred by the OFT. In a few cases we have information on costs imposed on businesses. The evidence collected so far shows that key areas of OFT work produce substantial benefits and provide high value for money: OFT's merger, CA98 and scams enforcement work are estimated to save UK consumers some £126m per year, compared to £28m

costs; the car warranties market study is estimated to have led to £120m-£170m benefits, compared to £300,000 costs.

3. Our evidence is structured as follows:

Part 1: Evaluation at the OFT

Part 2: Prioritisation effort

Annex: Individual studies

PART 1: EVALUATION AT THE OFT

4. The Office of Fair Trading routinely evaluates the effectiveness of its work through its evaluation team.
5. The evaluation programme covers both the OFT's competition and consumer work and aims to meet two needs:
 - External accountability: to evaluate whether the OFT delivers its objectives and does so cost effectively to the taxpayer and Parliament, and
 - Internal management: By highlighting where the OFT has had the greatest impact in the past, evaluation allows resources to be targeted towards high impact work in the future via our prioritisation process.
6. The evaluation programme contributes towards these twin aims of external accountability and good internal management in several ways. Firstly, the evaluation work comprises in-depth ex-post evaluations of discrete projects. These are contracted out to independent third parties with relevant expertise. Ideally, ex-post evaluations present a monetised estimate of the impact of the OFT intervention, identify remaining detriment in the market, and suggest ways in which the delivery of the intervention might have been improved to maximize impact.
7. Secondly, the OFT commissions research to analyze the wider impact of the OFT's work, beyond its direct impact on consumers. Ongoing and future projects of this kind include an assessment of the OFT's deterrent effect,

and an assessment of how effective OFT interventions against bid-rigging in the construction industry have been and what tools, complementary to enforcement, could be used to increase the impact of cartel enforcement work in this industry.

8. Thirdly, the OFT has started developing frameworks to estimate projects' impact at both the project go-ahead and project wrap-up stages. The OFT has started embedding anticipation of evaluation into its market studies, merger and scams work and plans to continue this effort in all key areas of its work, in order to improve the quality of ex-post evaluations. The OFT also aims to continue to improve the impact of estimation methodology it uses by seeking active feedback through seminars and publications.
9. Finally, the OFT has recently signed a performance framework agreement with HM Treasury (HMT) for the spending review period 2008-11. It commits us to provide quantitative evidence of how the OFT delivers direct financial benefits to consumers of at least five times that of its cost to the taxpayer across the spending review period. It also commits the OFT to estimate the additional wider benefits of OFT's work, for example the deterrence of future anti-competitive behaviour. The OFT has also committed to publish a project performance management system and to report annually on performance against it. The framework agreement explicitly commits the OFT to evaluate the impact of our market interventions and continue to develop a framework for prioritising work.
10. The programme of future evaluation work will be tailored to ensure the OFT is able to measure whether both the '5 to 1' target and other key performance targets have been achieved.
11. The OFT takes burden to industry very seriously and we try to minimise it (for example when asking for third party information on mergers and competition case investigations) to achieve results. However we have not attempted to assess these costs systematically in our evaluation programme and have focused on costs to the Exchequer instead. Some of the ex-post evaluations we have commissioned do assess costs to industry (see 'Consumer Codes Approval Scheme' below). In an ongoing study on the deterrence effect of the UK competition regime, we have asked 234

competition lawyers their views on whether our work has a cost to business in the form of 'business chilling'. We asked whether the UK competition regime deters mergers that would not be anti-competitive. 87 per cent of the lawyers interviewed thought this occurred rarely or never. 76 per cent of the lawyers interviewed thought the UK competition regime never or rarely deters agreements or conduct that would not be anti-competitive.

PART 2: PRIORITISATION EFFORT

12. To increase our impact the OFT is developing its approach to choosing the best projects to undertake, as well as carrying these out efficiently.
13. A number of the projects we undertake are prompted by complaints to us from businesses, stakeholders and consumers (via Trading Standards Services and Consumer Direct). We also use market intelligence and engagement with stakeholders to identify other competition and consumer issues that it would be appropriate for us to address.
14. In 2006 we published the criteria for prioritising our casework under the Competition Act (1998). Since then the OFT has restructured. Our new structure gives us the opportunity to prioritise across all areas of potential work (including competition and consumer casework, market studies and policy projects). In prioritising we consider first whether the OFT has a duty to act and then the costs and benefits of the work. Benefits can include gains to consumers, business and the economy by reducing detriment, deterring illegal behaviour, clarifying the law, empowering consumers to take more informed decisions and other relevant factors. The assessment also takes into account the costs and risks of the proposed work. Through this mechanism the OFT is able to allocate its resources to greatest effect.
15. We are already using our evaluation findings to understand which types of work yield the greatest benefits (see Annex) and, as our knowledge of effectiveness builds through our evaluation programme we will use this to inform i) where we seek ideas for future work and ii) how we prioritise between these ideas.

16. As this cross-office approach is new to the OFT we will review its progress to ensure that it is delivering the stream of high impact work that we believe it is our role to undertake.

ANNEX A: INDIVIDUAL STUDIES

A.1 The Annex summarises studies (carried out internally by the OFT or commissioned from external consultants) that show the impact of OFT work aimed at promoting competition. This includes:

Completed work

- Car Warranties Evaluation
- Positive Impact 2005/6
- Merger Impact document
- Review of the impact on business of Consumer Codes Approval Scheme (CCAS)
- Evaluation of Enterprise Act Training for Trading Standards Services (TSS)

Ongoing work

- Deterrence
- Positive Impact 2006/7

Completed works

Car Warranties (OFT Document OFT852)

A.2 In 2003, the OFT carried out a market study¹ into new car warranties. It called for an end to restrictions in some warranties requiring owners to have their cars serviced at a significantly higher price at the garages of franchised dealers.

¹ Market studies are instigated in areas where there are concerns that a particular market is not working well for consumers but where competition or consumer regulation enforcement action does not appear, immediately, to be the appropriate response. The studies examine markets, practices and regulation to explore whether the needs of consumers are being well served. They are exploratory studies to gain the best possible understanding of how markets are working. If a study reveals the need for further investigation or action under any of our enforcement powers, the OFT acts accordingly.

- A.3 The OFT commissioned Europe Economics to carry out an independent ex post evaluation of the impact of the 2003 study and subsequent actions. Europe Economics estimated that the total benefit to private consumers from the OFT's actions had been approximately £30m. Fleet operators and business users were far bigger beneficiaries with estimated benefits from the OFT's actions of £90m to £140m. These estimated benefits were based on increased ability to 'shop around' for the best price following the removal of warranty restrictions.
- A.4 These benefits compare very favourably with the £300,000 cost of the original market study and following actions.

Positive Impact 2005/6 (OFT 827)

- A.5 This document describes the evaluation team's initial impact estimation for the OFT's competition enforcement work. It finds that between 2000-2005, consumers directly saved at least £640m as a result of mergers blocked or remedied by confidential guidance, undertakings in lieu of a reference or referrals to the Competition Commission following public investigation². It estimates that consumers saved at least £110m from market interventions following CA98 infringement decisions over the same period.
- A.6 The estimates in Positive Impact 2005/6 are lower bound rather than best guess. It is highly likely that no less than the estimate figure was saved by consumers. This compares with combined OFT and CC competition enforcement costs of £98m for 2000 to 2005.

Merger Impact Document (OFT917)

- A.7 This document describes how we calculate 'best-guess' estimates of the impact of four of the OFT's merger decisions through the use of merger simulation techniques, rather than the lower-bound estimates given in Positive Impact.

² The consumer savings figure for mergers is therefore an estimate of the OFT and the Competition Commission's impact.

- A.8 Merger simulation relies on a few key pieces of data - such as market shares and profitability - to sketch out the economic relationships between firms and products in a market. It then uses these relationships to calculate the likely state of the market before and after the proposed merger. Comparing the two states reveals the likely effect of the merger.
- A.9 For one of the four mergers it was not possible to use the models. The results from the three cases where modelling was possible indicate that these blocked mergers would have resulted in a price rise of between 10 and 20 per cent. This leads us to estimate consumer savings of £52m, versus average costs for the OFT merger regime of £4m per year for the 2006-07 financial year when the mergers took place.

Review of the impact on business of Consumer Codes Approval Scheme (CCAS) (OFT870)

- A.10 The OFT's Consumer Codes Approval Scheme (CCAS) aims at promoting a set of rules a group of businesses agree to follow to set higher standards of customer service.
- A.11 The OFT's evaluation team contracted this review to Centre for Economics and Business Research Ltd (CEBR). The evaluation focused on whether CCAS had changed business behaviour, as it was too early to try and see a change in consumers' behaviour or provide a clear and unambiguous quantification of impact.
- A.12 CEBR's analysis focused on awareness, benefits and costs of the scheme, and also on the development of the scheme for the three sectors. The study's key findings were:
- OFT-approved code businesses offer more structured approach to customer service
 - Views on the scale and nature of benefits to business are mixed, although many of those spoken to were positive about the Approval Scheme's future impact

- Costs of implementing an OFT-approved code do not appear to be substantial: code member businesses estimate that ongoing compliance costs have only increased by 1.5 per cent since obtaining OFT approval
- the scheme has benefited code sponsors directly, enhancing their reputation and increasing demand for membership.

Evaluation of Enterprise Act Training for Trading Standards Services (OFT 549)

A.13 The OFT is responsible for promoting the new powers given to Local Authority Trading Standards (TSS) officers by the Enterprise Act 2002 (EA02), and supporting them in their use.

A.14 The OFT commissioned IFF Research to carry out an evaluation of the impact of the training and case support provided by the OFT. It was based on: focus groups and telephone interviews amongst TSS personnel; qualitative in-depth interviews with a mixture of TSS managers and TSS personnel.

A.15 It found that OFT training:

- is meeting the needs of trainees well
- has increased confidence in use of EA02 powers
- has led trainees to make greater use of EA02 powers.

A.16 It made a rough conservative estimate of £5m per year for the efficiency savings to be made by TSS as a result of EA02 training. The cost of delivering OFT training was estimated to be equal to £150,000 per year.

Ongoing Work

Deterrence

A.17 In May 2006 OFT commissioned Deloitte & Touche Llp to carry out a survey of competition legal practitioners with the aim of studying the deterrence effect of the UK competition regime (both mergers and enforcement of Article 81 and Article 82 of the Competition Act 1998).

A.18 Deloitte's preliminary findings indicate the following:

- For every merger for which the OFT finds a significant lessening of competition, there are at least 5 which are significantly modified or abandoned before the OFT hears of them
- The 5:1 deterrence ratio is the same for cartels
- For other commercial agreements it is 8:1
- For Abuse of Dominance cases, it is much lower (2:1).

A.19 Lawyers were also asked to what extent they thought the UK competition regime is effective in deterring cartels, other commercial agreements and abuse of dominance:

- 74 per cent agreed it was effective in deterring cartels
- 57 per cent thought it was effective in deterring other commercial agreements
- 46 per cent thought it was effective in deterring abuse of dominance.

A.20 Lawyers were also asked which factors were important or very important in deterring infringements:

- 85 per cent said fines
- 85 per cent said criminal penalties
- 72 per cent said disqualification
- 64 per cent said adverse publicity
- 48 per cent said private action.

Positive Impact 2006/7

A.21 This builds and develops further the methodologies used in Positive Impact 2005/6, and also estimates the impact of OFT scams enforcement work. It estimates that the OFT's merger, CA98 and scams enforcement work has saved UK consumers an average of £126m per year for the period 2004 to 2007.

A.22 Of this total, £52m is attributed to OFT merger work³, £64m to market interventions following CA98 infringement decisions, and £10m per year to OFT actions to stop illegal scams⁴. This compares to internal costs of £1m per year for scams enforcement, £4m per year for merger work, and £23m per year for CA98 enforcement for financial year 2006/7.

³The total consumer savings for the UK merger regime as a whole (OFT and Competition Commission) is estimated at £92m (\$184m) per year. Of the savings total for the OFT, £42m (\$84m) is due to undertakings in lieu of a Competition Commission reference taken by the OFT, and the remaining £10m (\$20m) acknowledges the OFT's role in consumer savings resulting from mergers blocked or amended by the CC following a reference.

⁴ The figure for scams goes back only to June 2005, the date of inception for the OFT's specialist scams unit.