OFFICE OF FAIR TRADING

Challenges and opportunities for the competition regime

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Thank you for giving me the opportunity to speak to you today. The UK economy currently faces serious problems caused by the recession and the associated severe negative impact on public finances. I would like to discuss the principal challenges and opportunities this poses for the competition regime.

This speech is particularly focussed on the competition regime, but it is important to stress that competition legislation and policy are just part of how the OFT makes markets work well for consumers. Competition and consumer policy are inextricably linked, and many of the examples I will draw on today will help to demonstrate why this is the case.

National and international issues and trends relating to climate change, globalisation of markets, the regulation of financial markets and banking, and the growth of the Internet and technology continue to pose challenges and feed into the mix, but I will put them aside for today and focus on the impact of the Government's response to the recession and the state of public finances. Almost two months into a new Government, we can begin to see more clearly some of the likely issues that will arise including the changing shape of public services, reducing regulation and the importance of innovation and choice. Underpinning all this, however, is a focus on the importance of economic growth to recovery.

Today I will briefly set out how competition policy can contribute to economic growth at little / no cost to the tax payer or businesses and the importance of a

strong, independent competition regime in ensuring that competition delivers across private and public sector markets. I will briefly consider the impact of public finances on the regime and the opportunities this may present to consider improvements for the regime as a whole.

Economic growth and the contribution of competition policy

The Government has many instruments to drive economic growth. While macro-economic issues and policy instruments have understandably received a great deal of attention, it is clear from the recent emergency Budget, and concerns about weak growth of aggregate demand internationally, that it will also be necessary to rely on micro-economic instruments such as the removal of unnecessary regulatory burdens and the protection and promotion of competition to drive economic growth.

Competition can stimulate growth in a number of ways, and it is worth noting that it can do so without adding costs to the taxpayer or to business. Competitive markets select the most efficient firms, and market discipline ultimately makes companies more competitive and more productive, driving efficiency across the economy. Competitive markets also benefit consumers by providing product innovation and lower prices.

It has thus been extremely reassuring to hear, over the last few weeks, the Prime Minister, the Chancellor, the Business Secretary and other senior members of the Coalition Government stress the importance of the role of competition in driving growth in these difficult times.

There has been much discussion of the various experiences of other countries when faced with similar economic circumstances, but it is worth bearing in mind that the suspension of the competition rules by the Roosevelt administration in 1933 is argued to have added to the duration of the Great Depression, and government intervention to restrict competition in 'structurally depressed industries' prolonged the Japanese recession in the 1990s. We must learn these lessons of history, and avoid repeating past policy errors.

The competition regime can make a positive contribution here in several respects.

First, strong enforcement, balanced with positive measures to improve compliance, can fight monopolies and cartels, and maintain vibrant efficiency-enhancing rivalry across the economy. Competition policy, by keeping markets open and allowing

entry by efficient new firms and business models, is an essential part of a positive business environment for enterprise and growth. In this way, the businesses, business models and sectors that will power the UK economy in the future will be selected efficiently through the choices of buyers in open markets.

In many UK markets, including cars, clothes, computers, white goods, furniture and groceries, the fruits of competition are clear. We can see that UK consumers and businesses have reaped huge benefits in terms of price, quality and innovation where competitive domestic distribution and retail have passed on the lower costs gained from greater international competition. This shows how competition can contribute to higher economic growth while keeping inflationary pressures down.

Second, competition policy has a potentially important role to play in adjudicating on business agreements and conduct that may on the one hand be efficiency-enhancing and on the other hand reduce competition. Clarifying this fine dividing line can bring substantial benefits in terms of enabling more efficient and innovative business strategies to succeed, while avoiding the attendant harm that can result if market power is increased. This is arguably an area where the UK competition regime could step up a pace. The OFT's recent introduction of the mini-opinion is one response to what we perceive to be a gap. While that is useful, we may, for reasons I outline below, need to re-examine intervention thresholds and ask whether we have shied too much away from tackling difficult issues, and if so, why?

Third, independent merger agencies can take decisions on mergers that are right for the long-term efficiency of the economy, avoiding using anti-competitive mergers in an *ad hoc* way to achieve other policy objectives at a very high cost for consumers and the economy.

In both these cases, political independence is hugely important in avoiding the siren cries of protectionism. Exit by failing firms is an important part of stimulating open and competitive markets; sometimes it is important *not* to intervene. In both these areas, I think the UK competition regime has generally a good story to tell and the challenge is to continue to improve the efficiency of the delivery of competition cases and mergers, supported by guidance and other measures to enhance compliance.

Fourth, joining competition and consumer policies enhances economic growth. There is the obvious point that they are intrinsically linked in that the analysis of one feeds into analysis of the other. Good consumer outcomes rely on competitive

markets to provide choice and value, while vibrant competition relies on consumers being able to shop around with confidence. Taking both of these aspects together means that individual markets can be looked at in the round, the most efficient instrument to tackle a problem can be selected, and new and innovative approaches can be developed.

Historically, consumer agencies have tended to regulate, often believing the answer to a problem is to introduce a new rule, law or licensing regime. Applying competition thinking shows that, in many instances, the market itself develops useful and innovative forms of consumer empowerment and protection and that regulation, in contrast, may risk pushing consumers away from making active, informed choices and learning from experience. In the opposite direction, the fact that an agency clearly acts in the interests of consumer welfare means that it will enjoy more support for its competition decisions, especially when the issues are complex or it decides that intervention, even if popular, could be harmful to consumers and the economy.

In addition, competition issues can be addressed through consumer interventions. For example, our work on personal bank accounts included a market study which showed the value of competition thinking for consumer cases. The research examined the characteristics of the main business models and revealed serious problems with transparency and switching, and real limitations on the ability of customers to control the charges they incur. Although the initial concerns expressed related to competition in the market, this research made it clear that the problems would be more susceptible to consumer remedies. This has also been the case in our work on letting agency terms, airline pricing and retirement homes, amongst others, and with several of the market investigation references to the Competition Commission, including PPI.

Fifth, the competition regime plays a key role in advising and intervening in the various aspects of government's involvement in markets: for example where regulation limits competition, where there is public sector monopoly, or where the government is trying to increase the use of market mechanisms to deliver public services. This is particularly relevant as the Government considers opportunities to change the way in which a number of public services are delivered. The competition regime's work includes, but goes beyond, traditional 'competition advocacy'. It advises on the design of new markets and opening of existing ones to greater competition, and has a role to play with regard to helping ensure competitive neutrality where public services are opened to competition. This is the subject of a number of recent papers by OFT, and is an area where we feel we

could usefully step up our level of engagement and activity further. However, as it is the subject of a speech I am giving later this week, I will stop there.

In order to ensure strong economic growth, tough decisions will need to be taken against a backdrop of varied but strong and well-organised vested interests including businesses, consumer groups, arms of government and those in the economy that depend on the status quo, or indeed have a desire to change it.

Economists often talk about 'rent seeking', which occurs when an individual or organisation seeks to earn income by capturing economic rent through exploitation of the economic or political environment, rather than by earning profits through economic transactions and the production of added wealth. John Kay has elegantly defined rent-seeking as appropriating wealth created by others, rather than creating it oneself:

> 'You can become wealthy by creating wealth or by appropriating wealth created by other people. When the appropriation of the wealth of others is illegal it is called theft or fraud. When it is legal, economists call it rent-seeking.'[1]

Rent-seeking is hugely inimical to productivity growth and efficiency. The free market rewards wealth creation and efficiency. Monopolies and cartels represent some of the best 'rents' available. But when government intervenes in markets, even for good reasons, it risks rewarding rent-seeking rather than efficiency. Regulations that weaken or reduce competition or create an unlevel playing field are particularly harmful. Even the signal that government may be open to such intervention can result in wasteful rent-seeking.

The economic recession has enormously increased the challenges here, particularly as the Government tries to open up markets to competition. With strong public finances and growing demand, it is easier to remove public restrictions on competition because positive economic conditions may offer some compensation to win over vested interests. Opening public services to competition is also easier in a growing market than a declining one. In addition, lobbying from the private sector, on the introduction of market mechanisms for example, may mean that the outcome, both in terms of delivering cost reductions and in services to the citizen, is sub-optimal.

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[1] www.johnkay.com/2009/11/11/powerful-interests-are-trying-to-control-the-market/

On top of this, incumbent interests will increase pressure on government to protect their own vested interests when times are tough, asking for special exemptions, for example through allowing potentially anti-competitive mergers, securing employment or introducing protective regulation. And given that the Government has little money to spend, policy makers will inevitably be tempted to turn to inadvertently restrictive regulation or potentially anti-competitive voluntary agreements.

Nor is rent-seeking and the protection or creation of vested interests solely the preserve of the private sector. The same behaviour in the public sector can carry similar costs and risks, and competitive mechanisms can play an important and useful role in avoiding this drag on economic growth.

A strong, independent regime

Business will support a strong regime that is seen to tackle both private and public restrictions on competition with equal consistency. They are strongly complementary: when markets are opened up, more enforcement will be needed to stimulate and protect competition; conversely, enforcement that really drives competition often results in rent-seeking lobbying of government for exemptions.

In addition, having a strong competition policy and regime in the UK may be an important shield against protectionism abroad. To date, the regime has played a key part in influencing the development of a policy of open markets, challenging protectionism and leading best practice in the EU and beyond. At a time when UK and western thinking about markets and regulation has been seriously challenged, there is great potential for the UK to maintain and improve its thought leadership in this area.

If the competition regime is to play a truly useful role, it needs to have a strong and independent voice. This is not just about independence in decision-making, but providing an independent input into the decisions that government and Parliament make about markets and how they are regulated, especially where the rules are (or have the potential to be) captured by or favour vested interests. It is not just about publicly presenting the evidence to oppose such powerful vested interests so that government has an alternative view point so as to reach a balanced decision. It is also about being able to tell government uncomfortable things when it risks being captured, and to challenge the status quo.

To do this, we need broad political consent about the role and independence of the competition regime which gives it the authority to behave independently. This includes being sufficiently strong to be able to say what we think without fear, and to withstand those instances where politicians decide, on balance, not to follow the advice. As with the Bank of England or the Office of Budget Responsibility, government needs an agency that feels sufficiently strong and independent both to tell it things that are uncomfortable and to go against vested interests in the best long-term interests of economic growth.

So what do we need? It would be helpful to have a broader statement reaffirming the importance of political independence for the competition regime, and a signal that would authorise competition advocacy in the way I have described it.

That still leaves the question of strength to take on difficult issues, and withstand decisions that go the other way. There must be a serious question as to whether the current fragmentation of the system will limit the effectiveness of competition policy, not least because there are several current policy suggestions that either propose or have the potential to result in further fragmentation (see below). It is relevant here because of a concern that, whatever the merits and attractions of sector-specific solutions, and they are many, it is important that we do not ignore completely the cost such fragmentation of policy may impose on the economy in terms of lower economic growth.

I have focussed so far on the positive outcomes that can result from strong competition policy, and I now wish to turn to the costs.

Public finances and the cost and efficiency of the regime

The question about the public finances is at the front of many minds, with the recent emergency Budget highlighting the need to make cuts overall of 25 per cent or more over the next four years. Both the OFT and the Competition Commission (CC) are currently in the middle of discussing our budget profile for 2011 to 2014, and, like the rest of government, we have yet to see what this will mean specifically for us but it is safe to say we anticipate further reductions.

It is important to have a balanced view on this. We have already faced significant budget cuts over the past three years, yet we have managed to improve our performance, increasing outputs and internal efficiency. We will all need to continue making significant efficiency savings as well as taking hard choices about some of the things we have always done. Ultimately, we will seek to implement

further cuts in a way that least impacts on our mission of making markets work well for consumers whilst keeping the burden on businesses and the cost to the taxpayer as low as we can. More importantly, we must look in a more innovative and fundamental way at how we most efficiently achieve better outcomes; how we best add public value.

The competition regime is no stranger to re-engineering processes to achieve better outcomes. Let me give some examples of the type of thing I mean:

- Perhaps the most striking example is the modernisation of EU competition law which enabled (in addition to subsidiarity within the enlarged European Union) greater 'co-production' of outcomes with the private sector (for example, self-assessment by business) and a focussing of public resources on the most harmful restrictions of competition. This has been manifestly beneficial for consumers and economic growth.

- Much more parochially, but still important, the introduction of the joint OFT/CC guidance for customer surveys in mergers better enables firms to gather evidence in advance of a merger notification. Where this avoids unnecessary references, it enables the regime to ensure the same level of consumer protection, with a lower burden on both business and the taxpayer.

- We have also focused on extending our engagement with business, particularly through understanding in more detail what factors drive businesses to comply with competition and consumer legislation and how the OFT can better support businesses in this work. We are confident that businesses will be more likely to support a regime that does not focus purely on enforcement but also engages through advice and guidance.

- And, perhaps a more subtle example is the revolving door that has grown up between the competition regime and the private sector. To the extent that advisors to business are better able to advise on fine lines and distinctions, business will face lower regulatory risk, thus enhancing investment. And, to the extent that staff in OFT have a better understanding of business issues and greater confidence in challenging them, the public side will also be more efficient.

All these examples have in common the co-production of the outcomes between the private and public sector. We have also improved and innovated our toolkit, for

example through the introduction of mini-opinions, and we have significantly reduced the cost and time of market studies while enhancing transparency and external engagement throughout the process to maximise consensus and to deliver better outcomes.

We have also pioneered new work on compliance, evaluation, prioritisation and other areas that has strongly influenced a more consistent, economic effects based approach to competition policy within the EU and internationally. I could give other examples such as revised or entirely new guidelines, increased public consultation and external engagement, or the OFT's proposals on private enforcement. We have made general efforts to reduce the burden on business with shorter information requests and other streamlining initiatives, including a newly created specialist competition team headed by Alastair Mordaunt. The Competition Commission has also undertaken a number of streamlining initiatives on both market investigations and mergers.

With tighter public budgets, we will need to think about how we can continue and expand these types of development. But the focus on reducing costs also presents an opportunity to re-think the role of competition and the regime more broadly. We can also examine whether we can, by clever re-engineering, achieve outcomes in a different way and make improvements to the regime as a whole. There are also possibilities for using competition to stimulate greater efficiency in public services. Indeed, a central part of the Government's response to the crisis has been to invite all of us to consider this type of big picture change.

One big risk in looking at changes to the regime is that we focus solely on reducing the cost to the taxpayer, and treat the industry-funded parts of the regime (such as our own credit licensing function) differently. To do that would simply create incentives to transfer the costs currently borne by the taxpayer to a type of levy on business. There would be no benefit to the economy, simply a shifting of the deadweight cost to a less visible and accountable area, and considerable cost, both in needlessly moving deck-chairs, but more importantly in allowing the industry funded elements to become a release-valve that removes the incentive and opportunity to make more fundamental change.

Looking at options for 'big picture change', a particular question relates to the set up of the competition regime itself. There are currently eight bodies[2] with competition powers and proposals to increase the number further.

For example, there are possible plans for Monitor to be given concurrent competition powers with regard to Healthcare. There are also possible implications for criminal cartel enforcement from the proposal to create an Economic Crime Agency. We believe that the creation of the ECA would be a positive move that will strengthen the UK's economic crime capabilities, and that strong links can be built between the OFT and the ECA to ensure the competition and counter-fraud regimes are mutually supportive and share expertise. We believe, however, that it is important that the criminal cartel offence should continue to be available to the OFT as part of our armoury of competition and market interventions.

This fragmentation is not a new issue: in 1999 Margaret Bloom recognised that the respective role of economic regulators and competition authorities was an area of lively debate in a number of counties.[3] The issue has also been considered by the House of Lords Select Committee on Regulators in 2007 and by the National Audit office earlier this year. While both reports make valuable contributions to the debate, and clearly identify the many benefits of the current system, neither suggested the type of fundamental re-engineering of the process of government that is currently encouraged.

One issue connected to this fragmentation is that sectoral regulators have often preferred to use their regulatory powers rather than their concurrent Competition Act powers for enforcement. In her recent article on 10 years of the Competition Act, Margaret Bloom suggests that this, combined with the fact that the OFT has concentrated on a small number of high impact cases, has meant that there have been significantly fewer Competition Act decisions than expected. She also notes

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[2] These are the OFT, Competition Commission, the Office of the Gas and Electricity Markets (Ofgem), the Water Services Regulatory Authority (Ofwat), the Office of Communications (Ofcom), the Office of Rail Regulation (ORR), the Civil Aviation Authority (CAA) and the Northern Ireland Authority for Utility Regulation (NIAER). This list does not include the European's DG Competition.

[3] Margaret Bloom, The Impact of the Competition Bill, published 1999 in 'Regulation and deregulation' edited by Christopher McCrudden, Clarendon Press

that the recent NAO report on the competition landscape expressed some concern about the lack of competition enforcement by the regulators.[4]

One idea that might be considered would be to require all concurrent regulators with competition (and consumer) enforcement powers to consider applying general competition and consumer law first, and only after that to resort to sector-specific ex ante regulation – in other words, to give competition (and consumer) enforcement primacy.

This would reflect the original principle of concurrency envisaged at the time of privatisation: that sectoral regulation would be withdrawn over time as effective competition was introduced into the market. According to the Littlechild Report on Regulation of BT (1983), 'profit regulation is merely a 'stop-gap' until sufficient competition develops'. Competition, it was considered, would replace the role of price-control regulation and would be in the best interest of consumers. There might still remain a role for the regulators to regulate the irreducible core natural monopoly elements of the market, but competition should replace regulation wherever this was feasible. Since the entry into force of the Competition Act 1998, concurrent regulators have made only two infringement decisions, imposing financial penalties, both for infringements of the Chapter II prohibition: ORR in the 2006 EWS case and OFGEM in the 2008 National Grid case.

The increased use of competition law would go some way to address a possible 'chicken and egg' problem whereby the pressure for ex ante regulation arises because the case law on general consumer or competition law is not sufficiently developed but the reason the case law is less developed is because we rely too much on ex ante regulation. It is certainly true that ex post application of competition and consumer law can take significantly longer than ex-ante regulation, so there would be an initial effect of not being able to address every issue quickly. Over time, however, bringing more cases would better enable case law to be applied more clearly. It would also enable us to press ahead with streamlining our process, something that we have already started and made progress with. And we would, in the process, put more responsibility on market participants, both buyers and sellers, to support the market in developing its own solutions.

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[4] Margaret Bloom, The Competition Act at 10 years old, Enforcement by the OFT and the Sector Regulators, CLJ, 2010

Whilst the use of competition policy in place of ex ante regulation provides clear benefits, I do acknowledge the potential risks. Regulated industries often have special circumstances that warrant them being treated differently than other industries. For example, regulators may want to be more interventionist given the need to promote and grow competition within recently public utilities such as energy and telecommunications - especially if their monopoly positions were state provided rather than a result of innovation. Trying to create exceptions within competition law in order to cater to these specific circumstances risks introducing uncertainty in its application, but this should not be incompatible with a more generic applications of competition law with horizontal and vertical agreement and mergers.

Ofcom's role in the broadcasting sector provides a model of how such a requirement to give primacy to competition (and consumer) law enforcement might work in practice. Applied across other sectors, this would move players in those sectors from ex ante regulation of consumer and competition law to a system of ex post enforcement with self-assessment (as was envisaged when the current regulatory system was developed). This could bring a number of important benefits.

First, it would reduce the regulatory burden on firms in these sectors, and, if concentrating activities brings efficiencies, fees (and their deadweight cost) could also decrease. As Irwin Stelzer recently pointed out[5], a heavy regulatory burden 'confers a significant advantage on big companies ... because they can comfortably bear the costs of coping with the regulatory process'. Bigger companies are also better able to influence the shape and content of the regulatory regimes they operate in, sometimes to the disadvantage of new companies or innovative processes.

There is also the risk that regulation can create a whole off-shoot industry. Where regulation divides revenue between companies, interconnection fees for example, firms can invest a great deal of resources managing the regulation. In a severe case, the regulator can then have to employ more people to deal with the firms, the court cases multiply, particularly as bigger companies are better able to exploit the complexities of the appeal process, and the scale continues to escalate.

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[5] "Saving Capitalism from the Capitalists", *the Weekly Standard*, January 18 2010.

Second, and more importantly, it would reduce the regulatory burden on new entrants. We see elsewhere how new entrants from other sectors or new business models across all sectors can be an enormous stimulus for greater competition and efficiency. Conversely, there is a risk in the current system that regulatory burdens focus on incumbents in the business, and not also entrants (including unseen ones).

Third, it could allow greater dynamic efficiency and innovation. General competition law allows firms to adapt their behaviour and self-assessment over time, whereas licence conditions may require a permanency that outlives their original motivation. Stelzer usefully makes the link between less innovation and why regulated companies frequently prefer this type of regulation. He writes that the industry:

> '...prefers the status of regulated monopoly to that of unregulated competitor because it knows the latter makes for sleepless nights, years in which individual company performance might be so poor as to cause heads to roll in the executive suite, and continuing pressure to innovate and lower costs. Regulated status, on the other hand, turns the focus of executive effort from the hurly-burly competitive marketplace to the more congenial, sedate hearing rooms of the state regulatory agencies that are being charged with enforcing profit limits.'

We need a stronger culture of competition and enterprise.

Fourth, many of the best competition (and analogously consumer) cases may lie in these sectors. A good case in one sector may have an enormous benefit across the system as a whole, but this positive externality may not be exploited. This may explain why there are so few abuse of dominance cases in the UK. As I pointed out in evidence to the House of Lords Committee in 2007, this may be because sector regulators prioritise around outcomes in their sector, whereas OFT prioritises the efficacy of the instrument across the economy. This change would align the incentives of the eight (or more) competition bodies.

As with any change, this policy shift would not be without risk. It would require some political courage because regulators would have less ability to use competition and consumer instruments to micro-manage market outcomes in their sectors. But it works at EU level and in many other member states of the EU.

It might also require OFT and others to step up to the plate and take on more cases that set difficult dividing lines as mentioned above. Indeed, I think we should

reflect on whether we have always made the most use of general consumer and competition law. Does the demand for an ex ante approach in part arise because competition law has stepped back from addressing certain issues? If so, we may need to take on more rule of reason cases, more non-infringement decisions, more abuse of dominance cases and consider whether in other areas the pendulum on intervention has swung a bit too far. The OFT's recent piloting of mini-opinions and the new specialist competition team represent an important step in that direction, but we should and will examine whether there is more we can do.

Requiring that all regulators first enforce competition and consumer law would be a useful first step, but it may not go far enough. As the NAO, John Vickers, and Philip Collins have all recently pointed out in different ways, there can be significant costs associated with duplication and inconsistency across the system. The various complex appeal processes for regulators, for example, may not be appropriate as they can take a lot of time, protect incumbents against rapid change, stall new entry and innovation and can cause delay in delivering better market outcomes. As the Institute for Government and others now regularly point out, policy across Government is too often made in silos, and the answer is not simply about realigning structures but actually re-aligning the service we offer, and the outcomes we achieve. While the various competition agencies continually work hard to reduce these risks, given the current economic climate, we may need to be asking whether there should be some consolidation across the regime, including the economic regulators. Even if these are not immediate legislative priorities, an early statement of intent over the life of the Parliament could have a very positive impact.

Conclusion

This Government recognises the critical role of competition in driving growth in the economy, but a reaffirmation of political support for a strong and independent regime would ensure the continued provision of honest and hard hitting advice to government on how competition can work best.

The UK competition regime currently measures up very well internationally, but it is not clear it has reached its full potential in terms of positive impact and least cost on the economy. The current fragmentation of the regime is something to be considered, particularly as this has developed in a way that was absolutely not envisaged when the regime was designed. Further fragmentation seems to be on the cards, and I am concerned that not enough consideration is being given to the

potential impact that such changes to the regime may have on the overall effectiveness of the regime now and in the future.

We face a number of challenges, and I would like at least to start a debate about what the OFT and others can do to maintain and enhance the competition and consumer regimes. An approach focused on an independent, streamlined and strengthened regime working across the economy would have the benefit of reducing complexity, increasing consistency, lowering deadweight costs and increasing the effectiveness of the regime and the growth of the UK economy.