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## Regulation - the second-best option?

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### Introduction

I welcome this opportunity to address this prestigious, and knowledgeable, audience in Scotland and I thank the Water Industry Commission for Scotland, and its Chairman, Sir Ian Byatt, for inviting me to give this Sixth Comiston Lecture.

As a competition advocate it is of great interest to me to see how the Water Industry Commission for Scotland is using its regulatory powers to actively promote competition and to develop a robust and open market for water in Scotland, for the benefit of Scottish customers. As Sir Ian mentioned in his introduction, in just 14 days time, and after a period of intense work to bring into being the necessary structures and systems, some 130,000 non-household customers in Scotland will be able to benefit from a competitive retail market for water and sewerage services for the first time. This is clearly a significant milestone in the sector, and I congratulate the Commission and all others concerned on the preparations they have made.

I know that there is another wider conversation taking place about the future model of ownership for the water sector here in Scotland. But in my comments today I do not need to refer to any particular ownership model. Developments within the nationally owned framework here and those in the privatised and mutually owned models in England and in Wales each illustrate the variety of opportunities to create competitive markets.

A few words by way of introduction.

My theme is that full and effective competition in open markets, supported by vigorous enforcement of competition and consumer law, generally produces the most efficient and productive market structures. In most sectors, separate regulation should not be necessary. Competition ensures that consumers benefit from a range of quality goods and services, at attractive prices, offered by efficient and innovative suppliers. Competition and consumer law provide for intervention in situations where markets are not functioning properly, to ensure that these benefits can, and do, flow to consumers.

But there are cases where competition and consumer law alone may be insufficient or inappropriate for securing these benefits – for example, in markets that are being, or have recently been, liberalised, as in the case of water and sewerage services in Scotland. Here regulation is an essential tool to help bring competition into a sector and it will have a key role in shaping and facilitating development of markets in which competition can flourish.

There is a wealth of evidence on how competition drives productivity and brings benefits for consumers. The OFT published a report in January 2007 summarising research that links competition and productivity, which is available on our website.

Competition is in particular the driver of sound investment decisions. In most markets competition is the most effective way of distinguishing good investments from bad. The provision of choice to consumers will enable them to demonstrate, through their purchasing decisions, where suppliers should be investing to meet their needs. Where markets are not working well poor investment decisions may be the consequence.

Competition is also the driver of innovation, of cost reduction and of efficiency. We just have to think about how many new products and services are brought to us every year - often at prices which are falling in real terms, and typically of higher quality - to see how quickly markets can change as a result of competition.

A great example of these types of effect is air transport which until comparatively recently was effectively monopolised, with regulated air fares. The advent of competition initiated through the process of Single Market liberalisation in Europe led to entry of low cost airlines and consequential effects in driving lower prices and value for money. It has also contributed to wider choice of destination, and more innovation - from booking methods to the range of frills (or not) associated with in flight service.

Many would argue that a regulator would not have been able to replicate the benefits achieved in the air transport sector. There is an inherent imperfection in the task of attempting to mimic how natural forces within a market would have driven the evolution of that market. Foreseeing accurately how both the supply and demand sides of the market might develop is hard enough and in any regulatory regime there is capacity only to act on selected features, and at intervals, not continuously as in a dynamic freely operating market.

Against this background, I will say something about what the OFT does. Then I will explore some of the differences between the perspectives and actions of a regulator and a body, such as the OFT which applies general competition and consumer law. Then I shall consider the overlap and complements between them.

## **What the OFT does**

Although the OFT does have certain regulatory functions in respect of estate agencies and consumer credit licenses, the OFT is not a regulator in the broad reach of its work. We do not have the same powers or role as WICS or the other regulators in the UK. The OFT's remit is to make markets work well – particularly in terms of the competition dynamic – for the economic benefit of consumers. Thus, the OFT does not determine what prices or terms and conditions should be in a market in the way the sectoral regulators can do, and it does not act to set structures, frameworks or conditions which provide a proxy for direct competition in markets. Rather the OFT acts to safeguard competition, so that firms have the opportunity to enter, expand and innovate and consumers can choose from alternative suppliers and offers, thereby providing the most effective stimulus for firms.

I will briefly summarise the functions and powers of the OFT and to give some illustrations of recent actions.

Competition law aims to safeguard competition against agreements between firms to frustrate competition (such as cartels) and conduct by dominant firms designed to exploit customers or diminish competition. Our actions in this area are designed to preserve the incentives of firms to meet customers' needs, and to safeguard the choices available to customers.

A recent example of OFT action against an anti-competitive agreement is our case against certain supermarkets and processors which involved alleged collusion regarding the prices of milk, cheese and butter some years ago.

In a very different sector, and closer to home in Scotland, anti-competitive conduct by a dominant local newspaper firm, Aberdeen Journals, was found to be limiting opportunity for consumer choice. In this case anti-competitive low prices were found to be designed specifically to price a new entrant competitor - the Aberdeen & District Independent - out of the local market.

Consumers across the UK, including in Scotland, will have been affected by the airline fuel surcharges imposed in concert by British Airways and Virgin Atlantic which were the subject of a case we brought last year. And the action that we took recently in relation to the international Marine Hoses cartel, including the bringing of the first criminal charges against individuals, shows our determination to stamp out price-fixing, market sharing and bid rigging.

Some sectors, such as construction, seem prone to these kinds of unlawful activity in the form of bid-rigging. After a series of smaller cases in this sector, we currently have in progress in that sector a significant case involving many parties and contracts.

In addition, our competition law powers include first stage review of all qualifying mergers to decide whether they give rise to a substantial lessening of competition. If so, the OFT must determine whether this can be remedied by undertakings at the first stage or needs in-depth review by the Competition Commission in a second stage.

We also have the power to refer markets to the Competition Commission where we have reasonable grounds for suspecting that features of the market prevent, restrict or distort competition. In the last couple of years, we have made a number of significant references – Supermarkets, Airports and Payment Protection Insurance – all of which have implications for markets in Scotland and for Scottish consumers.

The complementary set of functions of the OFT relates directly to consumers. Consumer law aims to protect customers from deceptive or misleading practices by suppliers which act to diminish customers' ability to make an effective choice. In this arena, the OFT works in partnership with local authority trading standards services, with whom we have particularly close links here in Scotland.

A recent example of OFT action in the consumer law arena concerns the fees charged on unauthorised overdrafts by banks. There is widespread concern about whether current accounts provide value for UK consumers, including those in Scotland, and in particular whether unauthorised overdraft charges and returned item fees are fair. So we started an investigation into the fairness of these charges under the Unfair Terms in Consumer Contracts Regulations. We have launched a test case to establish whether the test of unfairness under the regulations does in fact apply to these charges, as we contend - but the banks dispute. Pending judgment we are continuing our investigation into the substantive issue of whether the charges are unfair and are carrying out a market study which is taking a broad, strategic look at the market and especially at price transparency and consumers' confidence in switching.

Alongside our statutory competition and consumer enforcement powers, the OFT also employs a number of softer tools which promote self-regulation and stronger consumer confidence and empowerment – these include for example our Consumer Codes Approval Scheme.

Under the Scheme, the OFT approves consumer codes of practice that meet tough criteria on matters such as clear contracts, procedures for dealing with consumer complaints, low cost, independent redress mechanisms and prepayment protection. Those codes that meet the criteria and can demonstrate that they work in practice now display the OFT Approved Code logo. Through the use of the logo and appropriate promotional material and activities, the scheme helps consumers identify trustworthy businesses with whom they can be confident in making purchases.

Finally, we have a role in consumer education, leading the Consumer Education Alliance; and a role in advocacy to government where we help to ensure that policy options promote, rather than constrain, properly functioning markets.

The OFT mission is very clear – it is to make markets work well for consumers. Consumers are ultimately the end beneficiaries of all that we do.

## **Differences**

So how does the perspective and action of the OFT applying competition and consumer law differ from that of a regulator? After all, both are seeking to safeguard competition in face of powerful suppliers, typically including one or more incumbents with strong vested interests and new entrants who are seeking to enter. And both are protecting the interests of consumers who may well be uninformed or unaccustomed to exercising their choice.

First, there are inevitably subtle differences in objectives, given different starting positions. Regulators typically have a goal to nurture and encourage competition in a sector which has been, or is being, liberalised. They will seek to do so through the creation of appropriate frameworks, structures and incentives and through a process of extensive dialogue with all interested parties in the sector. The focus of the regulator's work is sector-specific and often incremental, opening up the market in steps. A competition and consumer authority such as the OFT, on the other hand, will typically be seeking to safeguard the conditions that ensure that the normal laws of supply and demand operate so that competition can thrive across the economy as a whole. Intervention is selective and only in cases where markets are not working well.

Then there are differences of focus. Regulation is specific to the issues of the sector concerned, while competition and consumer law are applicable generally across the economy. This has important implications which I shall return to but let me just layout one example. A regulatory intervention requiring third party access to a facility may be an important tool for a regulator but is sparingly used in competition law as it runs the risks of reducing incentives to invest.

Furthermore, the hurdle to justify intervention is typically higher for competition and consumer than for regulators. Competition law generally requires a legal test to be satisfied before any formal intervention can occur. Intervention is intended to be exceptional, rather than routine. The statutory basis of regulators' interventions, on the other hand, generally requires them to develop a market framework for the sector concerned which will allow competition to develop. A regulator has a far more continuous engagement with its sector.

In OFT interventions, we seek to strike the right balance in terms of when, and how, we intervene. In this we are fully aware that any individual case that lowers that threshold of intervention can have consequences across the economy by disincentivising firms. For instance, in the competition field

distinguishing predation from intense competition and anti-competitive refusal to supply from protecting commercial interests in new investments is never easy but is important in case selection. Regulators are better able to ring fence their decisions to specific sectors and thus limit unintentional spillover effects to other markets.

The point at which intervention takes place is also self-evidently different. Typically regulators determine *ex ante* what a company can or cannot do within the market framework that they design for the sector concerned; competition authorities tend to intervene after the event, and rely on *ex post* fines and other sanctions to create *ex ante* deterrence.

Regulation also imposes inevitable, but necessary, ongoing costs on the sector concerned, which will generally fall on all the companies in the sector and will have to be reflected in prices to consumers. Businesses are understandably concerned about the cost of any, so-called, 'regulatory burdens on business'. The costs of interventions under competition and consumer law are occasional and are borne by those directly subject to them.

Finally, regulators have a close relationship with the firms in their sector and a detailed understanding of the sector which is built up over time. Their intervention may be measured and nuanced in light of that specific knowledge and, as a result, they are better placed to act quickly on issues which arise. There is scope for informal settlements and arrangements which can be an effective way forward in promoting competition.

By contrast the OFT has a much broader canvas and our relationship with sectors and with the firms and issues within them tends to be occasional. Therefore our intervention is more formal and structured around, typically, a specific statutory provision. This does have some advantages: the risk of regulatory capture is much lower, and we can benefit from knowledge of how parallel issues have arisen and been resolved in apparently disparate sectors of the economy.

### **Overlaps and complements**

Despite - or even because - of the differences in the perspectives and actions of regulator and competition and consumer authority it is self-evident that they overlap and are complementary. Both are concerned with the pursuit of effective competition, and both are concerned with protecting consumers' interests.

Competition and consumer law can provide an important, necessary and secure backdrop for regulation, setting general parameters for what is permissible, and impermissible. Precedents from the case law can be applied or adapted in developing and applying regulation in a particular sector. Examples might include the length or terms of vertical agreements so as not to foreclose access to parts

of the market and the kinds of terms required to ensure fair, open and transparent access to facilities.

Furthermore, even in regulated markets, it will always be important to ensure that market players – both incumbents and new entrants - comply with the competition law so that, for instance, new entrants do not collude over tariffs or allocate customers or markets either amongst themselves or with the incumbent(s).

Regulation and competition law may be used creatively together to achieve better outcomes. An interesting and striking example at the moment is the way in which the European Commission is using both enforcement of competition rules, through a small number of individual competition cases, and proposed changes in the regulatory structure through greater liberalisation, to seek to bring about structural reforms in the energy markets in Europe.

There are also examples where a competition law action may be a valuable complement to other action taken by a regulator. In a couple of recent instances regulators have brought competition law cases where the company concerned had appeared to frustrate the intentions of the regulator in liberalising the market. For instance, Ofgem's recent action against National Grid and ORR's decision against EW&S.

Even where competition does develop there may be a need to guard against unfair tactics designed to mislead customers into switching suppliers rather than persuading them on the basis of a better commercial offer. OfCom's and OfGem's actions against mis-selling in their sectors are examples of this type of important consumer issue. To mitigate against this problem in the water and sewerage industry in Scotland, I understand the Water Industry Commission for Scotland is obliging new entrants to offer a standard service for a standard tariff. Regulators can be well placed to address these issues or indeed forestall them in the particular context of their own sectors. However regulating for every eventuality may be neither possible nor desirable and the general consumer law powers are there as a fall back.

Of course ensuring that consumers are empowered to be confident in switching suppliers and thereby activating and facilitating competition is essential if markets, whether regulated or not, are to work well. Here the work and experience of regulators and competition and consumer authorities can usefully be shared. I have already mentioned our work on bank charges. We have also done some work recently on consumers' ability to compare credit card offers. Here we are working with the Financial Services Authority to set up a price comparison site to assist consumers in making informed choices between competing offers.

Competition in some markets may be constrained by particular features which limit customer switching or search behaviour. These may not easily be

addressed by competition or consumer law enforcement, but can be, and have been, addressed by regulators. In relation to water and sewerage services in Scotland, the Central Marketing Agency which will facilitate the transfer of customer information between water suppliers in Scotland appears to be a clear parallel. Given that such factors are usually highly industry specific, it is the regulator, with detailed knowledge of the sector, who will be able to act most rapidly and appropriately.

Finally, there is the important issue of consumer redress where things have gone wrong. There is now considerable experience of redress schemes across the regulated sectors and our own Consumer Codes Approval Scheme requires all approved codes to have an independent redress mechanism.

### **Concluding remarks**

In conclusion, competition and consumer law complement and underpin sector-specific regulation, such as that which is the responsibility of the Water Industry Commission for Scotland. Although they are not best suited to opening up new markets and protecting consumers interests in those markets, they are nevertheless available to be used in addition to regulation where the circumstances require – unlawful agreements, misuse of market power, unfair contract terms, mis-selling and so on.

A shared common purpose - the pursuit of competition - means that there are valuable overlaps and complements between the two; and they can, and do, work together to ensure that markets function, whatever their historical evolution, for the benefit of consumers.

I shall follow the future evolution of the water industry in Scotland with great interest and I thank you for coming to listen to these thoughts on the relationship between competition and consumer law and regulation.