How to Succeed in the Senior Civil Service

Part 8 - Competition

8.1 Introduction[1]

You are more than likely to need to understand the basics of competition policy at some time in your career.

Competition is a key driver of **innovation**, **productivity** and the **efficient functioning** of the modern economy. All recent governments, all over the world, have encouraged competition - not just between businesses, but also between schools, between hospitals, and so on.

The result is that competition policy plays an important role in most government departments. The Business and Innovation departments? - Big Tech seems to be in perpetual warfare with competition authorities in the US and EU as well as the UK. Health? - competition between providers has played an important role in recent policy making whilst hospital mergers need to be approved by the UK's Competition and Markets Authority (the CMA). Sport? - Manchester City successfully used UK competition law in its 2024 challenge to the Premier League's Associated Party Transaction Rules. Energy? - Energy prices are constantly in the headlines and Ofgem is these days around the same size as its parent department. I could go on ...

Here are the main issues considered in this part of 'How to Succeed ...'.

First, competition in some sectors favours those 'with sharp elbows' - and this group seldom includes the poor and the vulnerable. And some businesses may need temporary protection

[1] This is a draft of the eighth part of a book which might be published in 2025. I am very keen to know what you think of it. Is it clear, helpful? Could the tone be improved? And the contents, of course! Please drop me an email to ukcs68@gmail.com .

from damaging competition. There needs to be a balance. This important policy issue is discussed in Chapter 8.2 below

Next, there is a rich ecosystem of regulators charged with countering the damage done when businesses[2] have too much market power. (Americans refer to this as **antitrust.**) You may need to have a basic understanding of how they operate, especially as they may stop you implementing what might otherwise seem sensible policies.

> Chapter 8.3 discusses the meaning of **market power**.
> Chapter 8.4 discusses how **merger control** prohibits mergers which may create companies with excessive market power.
> Chapter 8.5 describes the weapons available to regulators who are tackling companies that are engaged in **anti-competitive behaviour**.
> Chapter 8.6 describes how individuals and individual companies can take **private actions** to seek compensation from businesses that have engaged in anticompetitive behaviour.
> Chapter 8.7 briefly summarises a number of **current debates** in this area, and ...
> Chapter 8.8 lists some **other competition policy areas**, such as intellectual property law, which are not discussed in the book.

8.2 Competition

Competition is a key driver of innovation, productivity and the efficient functioning of the modern economy. These factors in turn drive improvements in GDP. But unrestrained competition can impose unacceptable costs on society, and in particular on the vulnerable. Here are the competing considerations:-

The Case for Competition

Much modern policy making is based on the assumption that it is generally a good thing if businesses, universities, schools and hospitals compete hard with each other. It encourages what Joseph Schumpeter called 'a perennial gale of creative destruction', encouraging the efficient allocation of resources, forcing individual organisations to be efficient and innovative and to meet the needs of their customers, students and patients. This efficiency and innovation together ensure that choice is maximised, novel products come to market as soon as possible, and prices and service standards meet the needs of most customers. Even in the health sector, reduced competition - as a result of hospital mergers - has been shown to damage patient care.

Competition is also good for suppliers and workers. The former need to be able to sell to companies that are innovative and thriving; both need to be able to seek other buyers or employers if dissatisfied with the way they are being treated. And the choices made by citizens, each on their own behalf but large in aggregate, are usually much better than decisions made by politicians or bureaucrats when it comes to the allocation of scarce resources.

There is also the point that markets don't pass judgment on the preferences they satisfy. Markets don't wag fingers. This is quite liberating.

[2] For simplicity, I generally refer to 'companies' and 'businesses' in this text but please note that individuals, charities and even government departments are also subject to most competition policies and legislation.

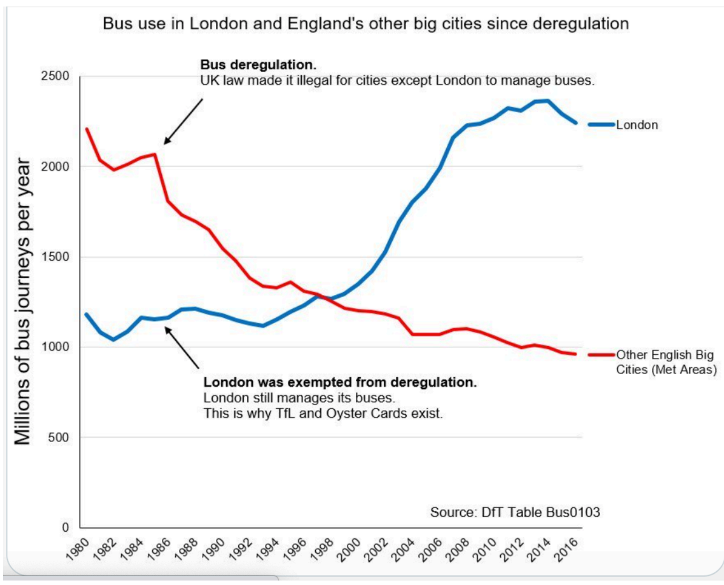
Stephanie Flanders, reviewing a book by Tim Harford, summarised the virtues of competition in this way:

> Why do economists like markets? ... Because, as Harford, explains, when a market is freely operating, everyone is forced to tell the truth. ... In a perfectly efficient market, the coffee shop can't lie about how much it cost them to make your coffee, because there would soon be a competitor next door selling it for less. And I can't pretend I don't really want that tall decaf latte I ordered, because the fact that I was willing to pay £3.50 for it showed the world I wanted it rather a lot.
>
> The result is that the right things are made in the right quantities and they go to the people who value them most. This is the idea of a perfectly efficient market, in which neither buyers nor sellers have any market power and lots of other crazy conditions are met, which critics rightly point out bear little relation to the real world. But Harford is good at showing why the efficient market story is still a useful one, and why rejecting markets has a cost.

But ...

Competition can lead to inefficient allocation of resources. This is particularly obvious in the case of transport where it can make a good deal of sense for operators to cooperate. It is very difficult, for instance, to travel north/south across London, Manchester and Glasgow because competing railway companies originally saw no point in joining their networks beyond their terminal stations.

The following chart also suggests that competition in the UK bus market was not welcomed by passengers:



More recently, US companies have shied away from working collectively, for instance to set joint emission-reduction targets, for fear that they might be breaking competition law.

And it is not always unreasonable to restrict employees' ability to go to work for a competitor. Professional footballers are an obvious example, but other employers may be justified in expecting their newly trained staff to hang around long enough to justify the cost of that training.

Competition also favours those with sharp elbows:- those who can shop around and who can force themselves to the front of the queue for excellent services, including education and healthcare. This group does not include the poor, vulnerable and other disadvantaged.

Michael Sandel, in *What Money Can't Buy*, points out that inequalities of wealth and income wouldn't matter very much if all they led to was the ability to buy yachts, sports cars and fancy vacations. But as money has come to buy more and more - political influence, good medical care, a home in a safe neighbourhood, access to elite schools - the distribution of income and wealth looms larger and larger.

Mr Sandel also points out that market reasoning tends to empty public life of moral argument. It is one thing to allow fast tracks at Disneyland. But private health care can start to shunt everyone else into long waiting lists. Ticket resale sites - and selling TV rights to major sports - can change the character of what would otherwise be important social events. And some environmental policies (such as tradable pollution permits and carbon trading) work by allowing wealthier folk to bribe poorer people to make unattractive sacrifices.

Another problem is that free (competitive) markets often fail to take account of the social costs that they impose on others - such as on the environment. That is why competition needs to be constrained by sensible environmental and other regulation. And let us not forget the huge costs that can be imposed on the rest of us by the failures in the financial markets that led to the 2008 financial crisis, and more recently to the problems associated with hyper-competition such as high frequency trading.

Just as important, perhaps, is the fact that, although competition is often the best way to ensure the lowest *average* prices and highest *average* service quality, it carries no guarantees about what particular outcomes will emerge, nor about which particular customers (or providers) will win or lose from the process. Competition in the energy industries, for instance, has successfully reduced prices in general, but it has particularly rewarded those who use more energy, can shop around, and can pay by direct debit. Disadvantaged individuals may therefore need to be protected by targeted regulation, whilst bearing in mind that this imposes a sort of tax on others - some of whom may themselves not be very wealthy.

So, as competing companies can sometimes behave very badly towards certain consumers, it is vital there is strong consumer protection legislation which is effectively enforced. Equally, consumers must not be over-protected from being able to make (what appear to outsiders to be) bad choices. Companies must be free to innovate in all sorts of ways, including offering products and packages which may not objectively appear 'better' than existing offerings

Switching

Nobody would, of course, be much bothered by the existence of inactive (lazy?) customers were they not all too often from the disadvantaged sections of our community - such as those with low incomes, poor numeracy, and/or limited access to the internet. Financial regulators, for instance, never tire of pointing out that a worryingly high proportion of the population do not understand percentages and so are incapable of judging the relative merits of financial products. And Ofgem and the CMA are very concerned about the high prices charged to those who pay for their energy via pre-payment meters. Unless great care is taken, these concerns lead to ever increasing regulation, much of it ineffective and evidenced by excessive paperwork and a plethora of *tick boxes*.

Sceptics, however, argue that - if many customers are paying too much for their energy, say - then middle men or new competitors will quickly move in to help them. Look at the growth of comparison websites, they say. These offer a much better solution than would yet more complex regulation. After all, none of us need a regulator to teach us that similar tomatoes can be bought at quite different prices in Waitrose and Lidl.

But this is an inaccurate analogy. Energy suppliers and financial institutions all too often offer exactly the same product at wildly different prices to different customers. They exploit their customers' ignorance or frailty in a way which verges on immorality. And it is of course much more difficult to switch energy supplier, or from one bank to another, than to walk into a different shop. The result is that '*price dispersion*' (price difference) is often much higher than could be justified by differences in the cost of supplying the product or servicing customers' needs.

Broadly speaking, therefore, the switching debate resolves itself into two issues - the need for consumer protection[3] and the existence or otherwise of effective competition.

Competition in Health, Education etc.

Competition in public services, such as health and education, is also heavily constrained by the following considerations:

- Expensive services (such as cancer treatments and university courses) have to be made available to the least well off in our society, not just those who can afford them.
- But the sharp elbows of the middle class often ensure that it is only the well-informed and/or the well-networked and/or the better off that can make full use of the ability to switch to a better school, or identify that excellent surgeon.
- The ability to choose a supplier has to be matched by there being a multiplicity of suppliers, which is hard to arrange in smaller towns and in rural areas
- There has to be sufficient spare capacity to accommodate transferring students and patients, and that spare capacity (under-used teachers, wards, doctors) has to be paid for by someone.
- Unsuccessful institutions have to be allowed to reduce capacity, or fail outright, as they lose their students and patients - but that always runs into serious opposition, including from staff and from the students/parents and patients that remain.
- And the customer might not always be right. The doctor with the best bedside manner might not be familiar with the latest most effective treatments. The university that most effectively sells itself to 17 year olds might not employ the best teachers. Even more worryingly, its teachers might mark generously so as to avoid upsetting students whose opinions will be passed on to those thinking of following in their footsteps.

Public service competition therefore needs quite firm, clear and occasionally complex regulation if it is to offer net benefit.

8.3 What is Market Power?

Governments in all modern economies have developed a range of policies which seek to balance one need (to grow large and efficient companies) against the other need (to protect customers

[3] There is a good introduction to consumer protection - and interesting subject in its own right - here:- https://www.regulation.org.uk/specifics-consumer_protection.html

against exploitation). They have also created competition authorities with strong legal powers aimed at preserving or increasing the extent of effective competition within their borders.

Most of the public, and most businesses, never need to engage with competition authorities. These authorities focus only on those larger businesses that have *market power*. This is because firms that enjoy significant market power can all too easily increase their profits by raising prices and restricting production.

> (This does not necessarily happen as a result of deliberate decisions to exploit their market power. All businesses need to re-evaluate their prices from time to time, and their executives will naturally be more reluctant to raise their prices if they will as a result lose significant business to competitors. But if the company has very few competitors, and no new competitors are likely to emerge, then it is likely to lose fewer customers following a price rise (as customers have limited alternatives to turn to) and so it is more likely to profit from raising its prices.)

It can be quite hard to decide whether a company has (or merging companies will have) sufficient market power to justify the attentions of a competition authority. One helpful approach is *the hypothetical monopolist test* which seeks to identify the smallest range of goods or services within which a hypothetical monopolist could impose a profitable significant increase in price. Having identified such a market, the authority can then decide whether the company's share of that market is high enough to cause concern.

8.4 Merger Control

The most obvious way to stop firms gaining too much market power is to prohibit mergers which seem likely to result in a **substantial lessening of competition**. This leads to the most common piece of competition jargon:- **'the SLC test'** as in "did they find an SLC?".

All competition regimes exempt smaller mergers from scrutiny. In the UK, mergers are exempt from scrutiny if the *turnover* of the firm being taken over is £100m or less and the combined firms will have no more than 25% *market share.*

> (Competition legislation is quite distinct from the Takeover Code. Companies that bid to acquire UK companies whose share prices are quoted on a stock exchange must comply with the complex rules in the Code, which is enforced by the very powerful Takeover Panel - a statutory body. This system is designed to ensure that shareholders are treated fairly, are not denied an opportunity to decide on the merits of a takeover, and are afforded equivalent treatment by an offeror.)

National Champions & Other Significant Companies

It is important to note that, outside certain *public interest* areas -see further below - neither the Government nor the CMA can block a takeover of particularly important businesses ('national champions') other than on competition grounds.

Ministers sometimes come under huge pressure to 'do something' to protect jobs and investment (such as investment in R&D) when significant UK companies might be bought by large overseas 'predators'. Although such purchasers are often willing to discuss their plans with the Government and others, and give commitments, these are generally worthless. Kraft, for instance, was heavily criticised for breaking a promise to keep open Cadbury's Somerdale factory in Somerset following its successful takeover of that British company. And it was far from clear that Pfizer could be kept to its promise to keep 20% of its worldwide R&D workforce in the UK, had it been able to buy AstraZeneca in 2014.

There are nevertheless a number of 'public interest' areas where the appropriate Secretary of State can issue an *Intervention Notice* so that they, rather than the CMA, take the merger decision.

Financial Services

This area was added in late 2008 when the UK financial services industry appeared close to meltdown in the wake of the worldwide financial crisis and the collapse of the UK's Northern Rock bank. It allowed mergers that would otherwise be prohibited.

Businesses with a role in public health emergencies

This area was added in June 2020 to deter takeovers of companies that are involved in combating, or mitigating the impacts of, public health emergencies such as the COVID-19 pandemic. This power could most obviously be used to block a foreign takeover of a company that was developing a potentially valuable vaccine - and to ensure that the vaccine was first made available to UK citizens.

National Security - and Infrastructure

The *National Security and Investment Act* became law in early 2022. It requires mandatory notification of proposed takeovers in 17 sectors including defence, energy and transport. The government said that it expected to receive over 1000 notifications a year requiring c.100 detailed reviews but probably only a small number of prohibitions.

Media Plurality & Broadcasting Standards

This area includes TV, radio and newspaper mergers. The legislation is very complex but, in short, the Secretary of State cannot intervene in the decision whether to block a merger on competition grounds - this decision is still taken by the CMA - but they can decide whether the merger is against the public interest because of it might reduce public access to a range of freely expressed views in the media, and/or to accurately presented news.

8.5 Other Weaponry

What can be done if already-large companies begin to behave anti-competitively?

UK competition authorities now have five weapons at their disposal:

- They can attack **'abuse of dominance'** - see 8.5.1 below
- They can attack **cartels** and similar misbehaviour - see 8.5.2 below
- They can use control the behaviour of **utilities** through licensing and other regulation - see 8.5.3 below
- They can mount **Market Investigations** - see 8.5.4 below.
- In addition, as of 2024, UK competition authorities have very wide-ranging powers to intervene to prevent or remedy abuses by the owners of large digital platforms. These

powers, which reflect frustration on the part of competition authorities with the breadth and complexity of competition problems arising from digital platforms (and that traditional competition law is too slow and cumbersome to react) remain untested at the time of writing but represent an interesting combination of competition law with faster, precautionary regulatory intervention. The EU has introduced similar powers.

8.5.1 Abuse of Dominance

This is arguably the most interesting, exciting and complex part of competition law all around the world.

We are all delighted when firms do something special to retain our business - not just by being efficient and customer friendly, but also by offering volume discounts ("*three for the price of two*", "*buy one, get one free*") and loyalty discounts such as airmiles, reward cards, Nectar cards and Clubcards.

But there comes a point when such behaviour begins to trap us. Companies are guilty of **abuse of dominant position** if competition authorities such as the CMA can show (a) that a company is dominant in their market, and (b) that they have taken steps to eliminate the limited competition that remains by unfair means, such as:

- temporarily reducing its prices so as to squeeze a smaller rival out of business, or
- offering price reductions and volume discounts to those customers who may be tempted to leave for a competitor, or
- refusing to supply customers who threaten to start buying part of their supplies from a smaller competitor.

None of the above behaviours are objectionable, of course, if they are carried out by non-dominant companies that are aggressively competing to retain customers. It is also often the case that markets do not work well for reasons which are to do with the history or structure of the market, rather than deliberate misbehaviour by individual companies.

In rare circumstances, a firm can be investigated for abuse of dominance even if it has done nothing to create that dominance - for example pharmaceutical makers facing little competition for drugs for rare conditions - if they seem to be exploiting that position through 'excessive pricing'. In general, UK competition authorities use these powers only for egregious and obvious excess, not to control prices that just seem a bit too high.

In practice, therefore, competition authorities have to carry out complex economic analyses in order to check whether the beneficial consequences of the behaviour (such as price cuts) are outweighed by the negative consequences (the elimination of competition).

Abuse investigations are always very hard fought. One problem is that dominance is hard to prove, and abuse of dominance even harder, given that much 'abuse' is regarded as feisty competition when carried out by smaller firms. Another is that executives of larger companies under such investigation often feel very aggrieved and complain that they are being penalised for being successful and having grown so large. And then, of course, the fines can be very large and the word abuse suggests serious wrongdoing. Companies and their executives inevitably fight such accusations very hard indeed, and the courts require competition authorities to have strong and compelling evidence. This in turn can lead to such inquiries ending inconclusively and/or taking a very long time indeed; four + year inquiries are not uncommon.

The European Commission and the American authorities have had some luck with victories over Microsoft, for instance, for incorporating ('tying') their browser and media player into the rest of their software. Google, too, has been the subject of major investigations. But successful UK investigations are few and far between. Market Studies and Market Investigations, which do not require the CMA to prove wrongdoing, have been much more successful - see further below.

Finally, in this section, it is worth reminding ourselves that dominant companies often feel understandably aggrieved when criticised for engaging in behaviour that is thought perfectly acceptable when carried out by their competitors. There is, unfortunately for them, some truth in this joke:

> You're gouging on your prices if you charge more than the rest.
> And it's unfair competition if you think you can charge less.
> But don't try to charge the same amount! That would be collusion!

So ... now on to collusion:-

8.5.2 Cartels etc.

It is illegal to enter into **agreements which prevent, restrict or distort competition**, unless specifically permitted by the competition authorities.

Franchise and similar agreements are often permitted, as is anonymised sharing of cost and other information, for instance via a trade association, is generally OK. But competition law prohibits supermarkets from agreeing a minimum selling price for alcohol, even though this would support the Government's alcohol policy. Similarly, competing railway and bus companies are not allowed to agree ticket prices on shared routes which can lead to very puzzled passengers.

Most other agreements not to compete are usually prohibited. Cartels are (usually secret) agreements not to compete, through price-fixing or market sharing or in other ways. Secret cartels are regarded as very serious crimes in the UK as well as in many other countries. Cartels are prohibited because they lead to customers paying more (and often much more) than they should for their products. Companies can be fined very large amounts (up to 10% of annual turnover for each year of the cartel) and individual company executives can in serious cases be sent to jail for up to 5 years and/or made to pay unlimited fines. In addition, customers can - at least in theory - seek compensation via 'private actions' in the civil courts - to get back the money they overpaid as a result of the actions of the cartel. (See Chapter 6 below)

It can be hard to prove that a secret cartel exists. There will be little if any written evidence, and all the members of the cartel have a vested interest in maintaining the secret. Competition Authorities (including the CMA in the UK) therefore generally offer **leniency** to the first cartel member to confess. Such **whistle-blowing** is a powerful weapon because one cartel member can never be sure that other members will remain silent, so the more nervous may quickly confess. This has proved very effective in busting several secret cartels, and no doubt deters the creation of many more.

Other cartel offences include:

- agreements not to compete in each other's markets,
- 'pay and delay':- payments by one company to another in return for promises not to enter a market (especially a rival pharmaceutical firm developing a generic competitor to some patented medicine), and
- bid-rigging, including 'cover bidding' where two or more companies secretly agree that at least one of them will submit a bid that us deliberately high or of poor quality during a competitive tender process, including in public procurement.

It is surprisingly easy to create a cartel. I shall never forget the look on my lawyer's face when I suggested that our small regulator should talk to other regulators about agreeing common pay scales so as to avoid bidding wars for particularly talented staff. And the American authorities forced Apple to pay compensation of $400m to 23 million customers when Steve Jobs openly asked publishers to raise their e-book prices on his platform so as to thwart the growth of Amazon's inexpensive Kindle library.

Perhaps my favourite cartel was organised by a manicurist who promoted 'National Nail Price Increase Day'! The CMA kindly let her off with a written warning.[4]

Resale Price Maintenance

Manufacturers used to be allowed to set retail prices, and withhold stock from any retailer who tried to compete with another retailer by selling at a lower price. But this resale price maintenance, which clearly prevented price competition, has now been illegal for many years. Limited RPM is however still allowed where thought necessary to deter price cutting achieved by making lower quality products - such as pharmaceuticals. It is worth noting, however, that the hard-fought abolition of RPM in the book trade does not seem to have destroyed that market. And, although legal RPM is still alive in pharmacies and pharmaceuticals, it is frequently criticised, not least for the damage it does to the finances of the National Health Service.

Exemptions, including Block Exemptions

Agreements (such as franchising or sharing R&D) are exempt from prosecution if they contribute to improving production or distribution, or promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit.

An agreement may be individually recognised as exempt by a competition authority or a court and, in addition, certain types of agreement will be treated as automatically exempt if they meet conditions set out in a 'block exemption' applicable to that category of agreements.

Most Favoured Customer?[5]

Competition Authorities are in a bit of a bind when it comes to investigating price promises and the like. Many customers would not use *Expedia, Booking.com* and similar websites unless they promise that they offer rooms etc. at the same price (or lower) than if you book direct with the

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[4] https://www.bbc.co.uk/news/articles/cld404v6lkeo

[5] The MFC phrase/acronym is by analogy with Most Favoured Nation (MFN) clauses in trade agreements whereby one country is prohibited from offering lower tariffs to other countries.

hotel, or via another website. But these *Most Favoured Customer* (MFC) agreements are fundamentally anti-competitive as they deter any competition between websites and/or between websites and the hotels. They tend to increase prices across the board and so such agreements between websites and hotels have accordingly been ruled to be illegal as a form of cartel.

Unfortunately, the result has been to encourage a switch to unilateral promises that the vendor will match a lower price offered by a competitor. (*John Lewis*, in the UK, is famous for its pledge that it is *never knowingly undersold*, a rather clunky way of making the same promise.) The obvious highly anti-competitive result is that no-one bothers to compete with the person making the promise, thus ensuring that the customer is denied the opportunity to save money by shopping around.

Although price comparison sites facilitate competition between suppliers such as hotels, they severely limit the ability of such suppliers to offer lower prices than shown on the comparison sites on which they pay significant commission. This tends to increase prices across the board. The CMA accordingly fined *ComparetheMarket* £18m in 2020 for preventing insurance companies from offering better deals through rival websites.

8.5.3 Utility Regulation

Most countries, including the UK, have *Economic Regulators* which act as a substitute for competition where there is limited competition or a natural monopoly. This is often the case in the utility industries where companies often have a natural monopoly in supplying energy, water etc. via wires and pipes which are expensive to duplicate.

Utility regulation is nevertheless a poor second best to, or substitute for, a properly functioning competitive market. The ground-breaking 1983 Littlechild Report included this forthright statement:

> Competition is indisputably the most effective - perhaps the *only* effective - means of protecting consumers against monopoly power. Regulation is essentially the means of preventing the worst excesses of monopoly; it is not a substitute for competition. It is a means of 'holding the fort' until competition arrives - if it ever does.

More than forty years on, regulators are still there. However, this is not because no competition has been introduced. The first utility privatisations – British Telecom and British Gas – were integrated monopolists of every element in the supply chain. For these and other industries, regulators or government have overseen a process in which potentially competitive businesses have been separated from 'natural monopolies', which are often the networks over which those businesses compete. When this is successful, regulators can lift price controls on the competitive businesses. Results are mixed: seemingly working well in telecoms and very badly in railways, with energy markets somewhere in between.

Although regulators are often seen as a useful agent for those who want to change the behaviour of utility industries in various ways, the principal purpose of utility regulation is to limit the economic harm that would occur if the naturally monopolistic elements of these industries were not regulated. Such harm would likely include inadequate investment and reduced innovation as well as higher prices, poor service and so on. Economic regulators accordingly aim to align the interests of the three key stakeholder groups: the providers of capital, the companies themselves, and their customers. It is wrong to think of the these three groups being adversaries.

Most of us think that such regulation is entirely focussed on protecting customers setting by setting price controls. It is, however, a lot more complicated than that.

Price, Quality, Range, Service

Hardly anyone buys a product or service just because it is cheap. In regulators' jargon, we endeavour to optimise PQRS - an appropriate combination of the price that we are charged (P), the quality of the goods etc. being sold (Q), the range of products and services made available (R), and the associated service that is offered to customers (S).

In an unregulated market, we choose the combination of P, Q, R and S that best suits us at a particular time. We sometimes choose to shop in a large supermarket, and we sometimes pop into our local store. We sometimes shop in a posh department store, and sometimes in Lidl. We sometimes have an expensive restaurant meal, and sometimes we drive through a McDonald's.

This fundamental fact poses real problems for those involved in utility regulation. Put positively, if market failure requires the imposition of regulation, then someone has to decide what quality, range and level of services should be provided, and at what cost. Put negatively, it is no use forcing prices down if the regulated company is allowed to provide a poor service to its customers.

This is an important issue for, amongst others:

- the water regulator which has the unenviable task of requiring water companies, such as Thames Water, to spend £ Billions to reduce water leaks and sewage discharges - with huge consequences for water bills;
- the energy regulator which requires network operators to meet targets for resilience (for example by building in redundancy) and pay compensation for outages due to network failures; and
- the communications regulator which requires Royal Mail to meet certain prompt delivery targets.

More generally, however, the trade-offs between price and non-price outcomes are better decided by elected politicians than by unelected regulators. The extent to which water bills, for instance, should be increased to pay to reduce water leaks and sewage discharges is a political decision. It is also much better for politicians to resolve the tensions between the needs of present and future consumers - such as whether current consumers should pay more for their gas and electricity so as to facilitate investment in green/renewable technologies which will benefit future generations. This subject is explored in greater detail in Part 7 of 'How to Succeed ...' - An Introduction to Regulation.

How Are Price Controls Calculated?

Once Q, R and S have been determined, the maximum level of permitted prices is generally calculated by adding together the following costs, assuming that the company is, or will become, reasonably efficient, and will become more efficient year by year:

- Operating Expenditure,
- Capital consumption (depreciation and the like), and
- Financing Costs (the cost of capital - dividends, interest etc. - in principle, a fair return to investors for financing past and future assets).

UK regulators generally put pressure on efficiency by using an 'Inflation-X' formula:- prices are allowed to rise in line with an inflation index less an X% reduction each year to pass on to customers the benefit of improved efficiency. The most common formula has been RPI-X but CPIH is gaining ground in place of RPI.

This formula works well in a wide variety of circumstances, mainly because there are three main players in the regulatory contest: the company, its investors and the regulator. Regulated companies, implicitly - and sometimes explicitly - supported by their owners/investors, will often kick up quite a fuss in the final stages of a price control discussion, claiming that there is no way that the company can meet the regulators' '-X' efficiency target, and trying to browbeat or scare the regulator into making further concessions. But the owners/investors change sides when the new price control kicks in, and will generally put a lot of pressure on the company's managers to become even more efficient than required by the price control and so make extra profits.

If the company succeeds in cutting costs faster than required by the regulator, there are then complaints from consumers that the companies are making excessive profits (even within the price cap). The regulator will typically respond by cutting prices yet further in the next price control period. This is sometimes done by imposing an initial P_0 price cut, followed by the usual cuts of RPI-X % pa. The company then responds by finding yet more cost savings .... and so on, to everybody's benefit?

But this merry dance can hide a great danger**.** John Kay points out that many - and sometimes most - people who work in utility companies are employed to stop things going wrong or to fix them when they go wrong. If all those employees were sacked then water and electricity would continue flowing whilst costs fell and share prices rose, along with executive remuneration. And the Prevention Paradox (see Part 2 of 'How to Succeed ...' - Understanding Organisations) would ensure that no attempt would be made to change course - until customers were poisoned or there was an extended failure of supply.

Low prices ... or ... Competition?

There is another wrinkle, which causes many utility regulators to lose sleep. They all want to encourage competition, if that is possible. But they also want low prices unless and until there is sufficient competition. But low prices make it very difficult for new companies to enter the market and compete with the incumbent. Some regulators do not therefore apply as much downward pressure on prices as might be expected by anxious customers, particularly in new industries needing new entry and investment (such as gas supply in Northern Ireland, or high-speed broadband everywhere).

The Cost of Capital

Price controls in capital intensive industries - and most utilities are highly capital intensive - are greatly influenced by the forecast cost of financing their operations. Arithmetically, this is calculated by applying an appropriate rate of return (the *Cost of Capital*) to the *Regulatory Asset Base* (the RAB). There is often much nerdy argument about what assets should and should not be in the RAB, and the appropriate cost of capital - but huge sums of money (and huge consequences for customers) depend on the answers to these questions.

Regulators estimate the cost of capital by first estimating the cost of risk-free borrowing, which ought to be around the cost of government borrowing - that is the yield on gilt-edged securities. They then add a premium to reflect the cost attributable to the additional risk of investing in that industry. This estimation clearly has to be done, but the amounts at stake mean that the process is hard fought, for the scale of capital investment in some industries means that even a 0.1% shift in cost of capital can hugely increase or reduce allowed prices - and hence profits. But no-one can ever be happy that they know the right answer. Professor Alan Gregory, writing in 2007, noted that studies had shown that the prospects for being able to estimate the cost of capital with any degree of accuracy were fairly bleak, and that even 'fairly bleak' might be an understatement.

The RAB and Risk Allocation

It can be equally difficult to decide what should be included in the Regulatory Asset Base.

Utility companies sometimes have to make huge investments which can only be justified if they will be used and paid for over decades. Financially, therefore, these are very risky investments, however socially and economically sensible they may seem. Heathrow's third runway and Thames Water's Tideway Tunnel are good examples. How should this risk be allocated between investors, customers and wider society?

To the extent that effective competition cannot (yet?) be achieved, and to the extent that politicians don't want to take such decisions themselves, the regulator has to allocate risk between investors, customers and society more generally. Their general aim is to allocate risk to those best able to manage and/or bear it. Regulators may therefore need to require current customers to meet the cost. This leads to current air passengers being asked to pay for Heathrow's third runway, for instance, even though they will probably never use it themselves. Much the same applies to investment in water infrastructure.

Access

It is generally the case that a new entrant into a market, seeking to attract business away from an incumbent operator, will need to be given access to certain shared and/or 'downstream' services. (Downstream services are those nearer the final consumer.) Examples of facilities and services that might need to be shared include pipes and wires, railway tracks and postal deliveries. Access generally needs to be enforced by a regulator keen to encourage competition.

8.5.4 Market Investigations

What can be done about companies that have grown very powerful and face limited competition? As we have seen (above) it is very hard to show that they are abusing their dominant position, and even successful abuse investigations take many years.

The good news is that in the UK (though not in most other countries) it is possible for competition authorities to investigate and remedy problems in markets which do not appear to be working well. The CMA or another regulator first carries out a **Market Study** following which it can either make recommendations to the industry or to government (e.g. for regulatory action), or it can decide to carry out a full **Market Investigation**.

The CMA has extensive powers to remedy market failures by imposing behavioural conditions or forcing companies to sell part of their business. These very strong powers are in practice used quite rarely, but they can be valuable where a market appears to be failing, or where privatisation has created a company with significant market power. They were introduced after the Second

World War in order to break up the cartels that had been a necessary feature of the wartime economy.   Here are two examples of their recent use.

- The CMA's predecessor authority investigated UK airports between 2007 and 2009 and required BAA plc (which owned many of the previously privatised airports) to dispose of Gatwick, Stansted Airports, thus increasing competition in the South-East of England, including for Heathrow, which BAA retained. BAA were also required to dispose of either Edinburgh or Glasgow Airport, this increasing airport competition in Central Scotland.
- One high profile Market Study - completed in 2019 - concerned the accountancy industry and the very large market share of the 'Big Four' companies in large audits. The CMA worked quickly and made some controversial recommendations to government, but it might have been better if there had been a more thorough Market Investigation which could have led so the CMA imposing its own remedies, rather than relying on politicians to take on significant vested interests.

The CMA's powers are in some ways quite extraordinary. They can make *Orders* which are legally binding on businesses that were not part of the original investigation. For instance they can require a range of businesses to publish or publicise particular information which the CMA believe would make the market work more effectively. BAA's lawyer claimed - probably accurately - that the forced sale of three airports was "*just about the largest individual forced transfer of land since the Reformation*".

Legislators are earning that market investigation powers can be very useful (and necessary) when facing the power and complexity of today's 'Big Tech'. The EU's Digital Market Act accordingly gives the European Commission very similar powers. And the 2024 announcement that the US Dept of Justice might seek the break-up of Google suggests that similar thinking is developing the other side of the Atlantic.

8.6 Private Actions

It would obviously be good if the victims of cartels and abuse of dominance could easily and successfully claim compensation from their suppliers, for this would counteract the economic harm that had been done by the cartel. Indeed, many in government hope that such 'follow on' private actions might over time allow the competition authorities to devote less resource to cartel busting. There was a feeling that larger companies should be left to pursue their cartelised suppliers through the courts, thus cutting the cost to the taxpayer and perhaps also acting as a much greater deterrent to future cartels.

It has in practice been difficult for individual customers to successfully mount such private actions. The Government has therefore also introduced legislation intended to make it easier for businesses and others to bring '*collective proceedings*' (often called *class actions*). The necessary legislation in particular permits '*opt-out*' class actions, as a result of which all claimants would eventually benefit (if the action is successful) even if they knew nothing about the legal action.

The first significant collective action was launched in September 2016, on behalf of its many millions of card-holders, when *MasterCard* was sued for £14 billion. The European Commission had previously found the company guilty of abusing its dominant position by imposing excessive charges on the use of its credit and debit cards. And several retailers had successfully claimed follow on compensation. But this litigation is still unsettled eight years later, a sign that it is both hard-fought and that the legislation is ineffective, at least as a deterrent.

There have since been a number of other lawsuits, underwritten by cash-rich litigation funders in return for a slice of any compensation. Sony PlayStation, for instance, is being sued for up to £5bn over allegations that it abused its dominant position and overcharged nearly 9 million gamers. Other litigation involves BT, Amazon, Google, Meta/Facebook and Apple.

But ... there has, as of early 2025, yet to be significantly successful litigation (unless you are a defendant). It has been reported that the Mastercard case will be settled for around £200m, not £14 billion. And BT successfully defended the claim that it should pay compensation of £1.3 billion.

8.7 Some Debates

Those designing and operating competition policies sometimes need to choose sides in these debates:

- What about the public interest - jobs, growth etc.? - see 8.7.1
- Effects-based v. form-based decision making? - see 8.7.2
- Harvard's economists v. Chicago and Austria - see 8.7.3

8.7.1 The Public Interest, Jobs & Growth

There is understandable concern that competition authorities and other regulators might become (or at least appear to be) over-zealous in their scrutiny of high-tech companies in particular and so deter inward investment and reduce the pace of innovation. These concerns have come to a head as the UK, EU and others have given their competition authorities powers to intervene faster (and therefore with out the usual hundreds of pages of evidence and analysis) against the very largest digital platforms.

Others stress the need to guard against regulations which protect firms - and especially incumbent firms - with vested interests.

Employees of takeover targets (and their political and union representatives) are inevitably worried about post-merger efficiencies leading to job losses and localised or regional economic damage.

There is a related danger that the sale of bright young British companies to their larger overseas brethren might lead to valuable technology leaving the country.

And there is occasional tension between (a) those who want to create 'national champion' businesses by encouraging firms to merge, and (b) competition authorities who generally resist mergers which substantially reduce domestic competition.

Some of these concerns clearly pull in opposite directions. Here is the current state of play:

Modern UK competition law can be traced back to the imperative to grow the economy after the Second World War. The Monopolies and Mergers Commission was given two tasks. The first was to dismantle the monopolistic cartels which had been encouraged during the war in order to speed production. This legislation now takes the form of Market Investigations - see 8.5.4 above. The second task was to deter mergers which might create monopolies.

The newly formed authority was asked to advise ministers (who were then the decision makers) on whether mergers etc. were *'in the public interest'*. They could thus take into account likely consequences such as improved efficiencies arising from economises of increased scale - and job losses.

This approach survived until the mid-1980s when it was generally superseded by the much simpler **rivalry** test, formalised in legislative form in the 1990s in the question whether a merger would likely lead to a substantial lessening of competition - see 8.4 above. Jobs could no longer be protected, but the economy would grow faster (and more jobs would be created) as a result of the resultant rivalry, competition and economic dynamism.

UK and other EU authorities therefore nowadays generally apply the rivalry test when assessing the benefits of otherwise of a prospective merger. Does the merger result in a substantial loss of competition? They are not required to prove that a substantial loss of rivalry will lead to harm to consumers. EU/UK legislation and jurisprudence proceeds on the basis that rivalry/competition leads to dynamism which is inevitably good, even if its direct effects cannot be measured or estimated. It is possible for companies to argue that benefits to consumers (for example from investment) can outweigh this harm, but these arguments are rarely successful. One advantage of this approach is that it is relatively simple to operate.

Consumer Welfare

But the rivalry test cannot be used in assessing whether there has been an abuse of dominance - see 8.5.1 above. Competition authorities therefore need to assess the economic consequences of restrictive agreements and other exclusionary behaviour. They usually apply a consumer welfare test - in effect asking whether the behaviour is likely to lead to consumers experiencing a detriment such as higher prices or lower quality.[6]

Some overseas authorities, such as the Germans, nevertheless take a harder line, preferring to use something more like the rivalry test when assessing market behaviour. They are thus rather more likely to object to apparent abuse of dominance. This in turn helps preserve their *mitttelstand* of medium sized, often family-owned, businesses.

It is more difficult to apply the consumer welfare test to mergers. This would involve carrying out a form of cost benefit analysis in which the efficiency benefits of the merger (economies of scale, head office functions etc.) are compared with the likely detrimental effects (increased prices as a result of greater monopoly power, etc.). This is a much more complex approach and so open to greater argument. Its theoretical advantages are therefore generally reckoned to be outweighed by its practical disadvantages.

Total Welfare, The Citizens Interest etc.

Some economists argue that authorities should compare the advantage to the industry following a merger against the likely detriment to the consumer. Under this total welfare approach, higher prices etc. would be permissible if they were offset by higher company profits.

There is, on the other hand, occasional quite strong pressure for a return to modern versions of the old public interest test (see above). A small but growing group of (what some disparagingly

[6] Consumer welfare is, however, a somewhat slippery concept. Arile Azrachi (see footnote 8) notes that "Every [lobbyists'] favoured policy is said to promote consumer welfare".

call) 'happiness economists' are now arguing that for a host of new factors for antitrust policy to be addressed, while also attacking 'bigness' per se. They believe that focusing on consumers overlooks other values, including vibrant small businesses, variety on the High Street, innovation, privacy, job losses and healthy democratic processes. For them, large companies by their very nature pose a unique danger to the economy and society.

Although these arguments have political and other attractions, competition law need not take account of these factors in order to play its part in a system promoting well-being. A law can have a narrow and immediate focus while still having broad and long-term beneficial effects. Laws against theft do not provide for an assessment of the well-being or welfare effects of transferring property from its original owner to the thief (indeed, they might be less effective in promoting societal well-being if they did). Any law is part of a system of laws, so competition law does not need to do everything.

There is also the point that “If you chase two rabbits, you will catch neither one” - a lesson that applies just as strongly here as it does in the case of other areas of regulation.

A 2018 paper by John Davies[7] analyses these arguments in a very interesting and accessible way. However, as Ariel Ezrachi points out in his brilliantly-titled *Sponge*[8], competition law is in practice always susceptible to national priorities backed up by sometimes intense lobbying.

UK competition law, for instance, recognises that 'the national interest' is sometimes so strong that targeted public interest investigations can be justified. These exceptions are listed at 8.4 above. Similar pressure has recently led to ministers requiring the CMA and other regulators to encourage **growth** alongside their other responsibilities. The CMA's reaction seems to have been similar to that summarised above - i.e. there doesn't need to be a fundamental shift in their approach; their current rivalry and consumer welfare tests lead directly to growth. But they have developed considerable expertise in areas such as supply chain resilience, AI and how competition impacts investment. This should help them avoid making decisions with unforeseen and unwelcome consequences.

The CMA and other competition experts certainly resist any general encouragement of national monopolies in the form of **national champions**. There is similar resistance at the European level, as typified by the proposed 2018 merger between Siemens' and Alstom's railway businesses. It was on the face of it a clear candidate for prohibition by the EU Commission - and it was indeed duly prohibited in early 2019 - but the companies, backed by Chancellor Merkel and President Macron, argued that the EU needed a European champion to compete effectively with China's CRRC which benefits from huge Chinese government support and preference. Several distinguished academics wrote an open letter in connection with the case. Here are some extracts:[9]

> More, not less, competition is needed in Europe ... The argument that it is sufficient for two firms to merge and increase in size to become more competitive in the international markets is fallacious. Siemens and Alstom are already leading firms in the international markets, and as such already benefit from important economies of scale and scope. We have not found in the public domain any explanation of why their union should give rise

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[7] https://www.regulation.org.uk/library/2018-John_Davies-Means_and_Ends_in_Competition_Law_Enforcement.pdf
[8] https://www.regulation.org.uk/library/2016-Ariel_Ezrachi-Sponge.pdf
[9] https://www.competitionpolicyinternational.com/wp-content/uploads/2019/02/Open-letter-on-European-champions-with-signatures.pdf

to significant efficiency gains (and the European Commission states in its press release that the companies have not substantiated any such efficiency claims).

Absent efficiencies from the merger, the elimination of competition between Siemens and Alstom may well increase profits, but it would make the merged firm less competitive in international markets and harm its customers, such as train operators and rail infrastructure managers, which will likely have to pay higher prices and enjoy less innovation and quality, and ultimately final consumers. Unsurprisingly, customers have strongly opposed the transaction (had Siemens become more competitive after controlling Alstom, actual and prospective buyers would have been the first to welcome the merger).

...

If anything, the mounting empirical evidence on increased market power and concentration call for stronger competition enforcement, responding only to impartial efficiency criteria and not to political opportunism. Europe needs more efficient, competitive, and innovative firms. Sponsoring mergers which remove competition would achieve the opposite.

8.7.2 Effects-based v. Form-based Decision Making

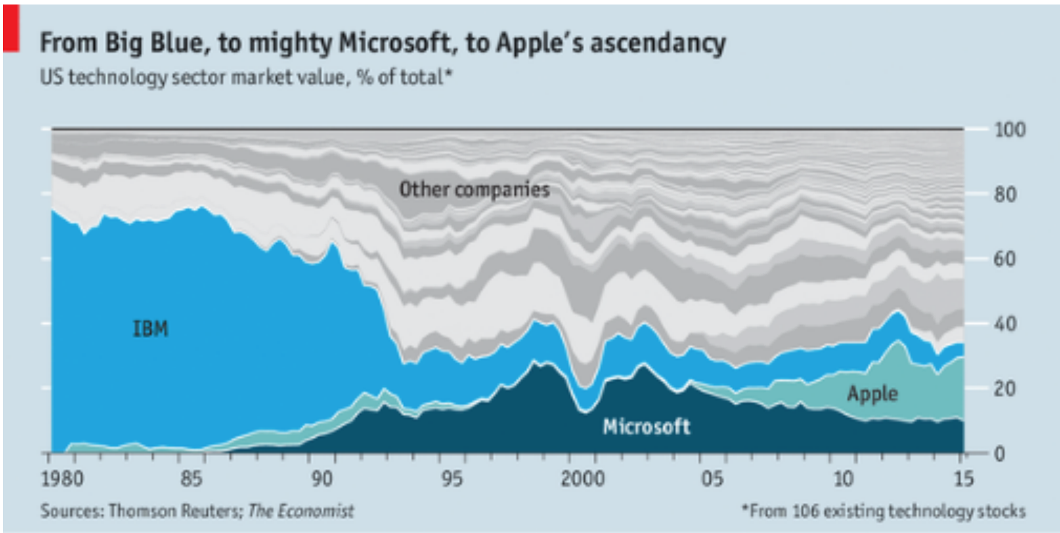
Legislators and competition authorities can in principle also choose between two quite different approaches to deciding whether particular activity is illegal. The form-based approach requires the regulator to do no more than to look at the behaviour of a company and decide whether it is inherently or intrinsically illegal. (Lawyers talk about behaviour being illegal *'per se'*.) Secret price fixing cartels clearly fall into this category.

But the *per se* approach does generally require there to be clear threshold criteria for illegality. For cartels this is simple – don't talk to your competitors about prices or future plans – but, for abuse of dominance, these can be hard to define. There has therefore been a general trend in the US and Europe for authorities instead to examine the economic *effects* of potentially anti-competitive behaviour. This alternative approach is called 'effects based' or 'economics based' decision making and this is now generally preferred, at least in most abuse of dominance cases as well as merger control. (See also 8.7.1 above.)

The one big attraction of the form-based approach is speed of operation, allowing *ex ante* (before the event, or prohibitive) action, rather than relying on *ex post* (after the event) action which allows maybe irreparable damage to be done before time-consuming analysis begins (often impeded by information asymmetry) and eventual decision and punishment. This choice is accordingly part of the *ex ante* v. *ex post* debate within the wider debate about the ineffectiveness of much regulation. This subject is discussed in more detail in Part 7 - An Introduction to Regulation.

8.7.3 Harvard, Chicago & Austrian Economics

Competition policy debates often tend to resolve into disputes between those who favour intervention (the Harvard School of economists) and those who have greater belief in the long-run efficiency of markets and are relatively sceptical about the effectiveness of government intervention and regulation (the Austrian and Chicago Schools). The latter are more likely to believe that competition will erode high profit margins and that markets may be contestable if not actually currently contested. (In other words, they believe that apparently powerful companies will often not exploit their market power for fear of being taken by surprise by a new entrant.) Their favourite chart, showing the successive reductions in the power of IBM and Microsoft, is below.



Chicago/Austrian School economists still object to hard core cartels, and mergers which create monopolies, but are sceptical that apparently predatory behaviour does any harm, and contend that most oligopolies (and particularly 'vertical' agreements between upstream and downstream supplier) do very little harm.

There is these days relatively little support for pure Chicago/Austrian School economics, but there is also a good deal of concern that regulatory interventions can all too easily lead to unintended consequences. Most competition authorities therefore sit somewhere between the extremes characterised by the two schools of thought, and increasingly employ econometrics and game theory to analyse potentially problematic behaviour.

8.8 For Completeness ...

... I should mention that there are three other competition policy areas which are a bit too specialised to be covered here.

Intellectual Property Law, such as patent protection and copyrighting, grants time-limited monopolies to designers, inventors, authors etc.

'State Aid' is shorthand for Government and local government protection, preference and subsidies. Our own state aids - such as support for our vehicle and stell industries - can form a valuable element of industrial and social policy but they should be deployed as little as possible as they do distort competition and can delay necessary economic adjustments.

If the government believes that overseas competitors are excessively subsidised and so competing unfairly with UK businesses then it can impose import duties to increase prices to where they should be. *Anti-dumping duties* are imposed on individual importers who are selling stuff below prices that they charge their domestic customers. *Countervailing duties* are imposed on all imports from specified countries so as to offset the benefits derived from subsidies.

8.9 And finally ...

I am hugely grateful to my colleagues in the Regulatory Impact Unit, the Postal Services Commission and the Competition Commission who taught me just about everything in this text, and particularly to economist John Davies who suggested numerous valuable improvement to my earlier draft. The errors that remain, and the occasional strident opinion, are of course mine alone.