

Regulation and Competition – Chalk and Cheese? The Role of the Competition Commission

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I. Introduction

It is a great privilege to be speaking at Bath University at this important CRI Conference. Promoting sensible discussion of regulatory issues is very necessary in this regulatory age and the CRI is to be congratulated for what it has done – and does.

The title of my talk is “Regulation and Competition – Chalk and Cheese? The role of the Competition Commission.” This expresses the view that the two do not easily mix. I am going to talk, however, about the interaction between regulation and competition. I will suggest that the boundary between the two is not clear and that attempts to draw a sharp distinction ignore what happens in practice. And I will seek to show how the Competition Commission (CC) in particular bestrides the dividing line (if indeed there is one) and is well-equipped to carry out competition and regulatory functions through its market investigations and regulatory reviews. I will conclude that without an appropriate degree of use, however, these functions may atrophy.

II. A stylised view?

“Regulation” is popularly supposed to be “*ex ante*” and flexible, enabling “regulators” to control the activities of natural (or unnatural?) monopolies. Once markets have “opened up”, competition comes into play and competition law (applied “*ex post*”) can be used. Thus, in the ideal world, “regulation” gives way to “competition”, except when (natural) monopolies persist. Retail telephony is thus deemed to be suitable for deregulation; local water services less so.

This is a somewhat stylised view of how regulation and competition interact with each other, but it is quite prevalent.² However, things may not be quite so simple. First of all, not all competition interventions are “*ex post*”. For example, market investigations carried out by the CC are “*ex post*” in the sense that they assess how markets have worked in the observable past, but are “*ex ante*” in their assessment and prescription of remedies.

Secondly, and obviously, regulatory and competition roles are typically combined and fulfilled by single authorities in the UK. Apart from the CC’s own particular position, the main economic regulators in the UK have “concurrent” competition powers giving them a choice of measures to use.³

¹ Chairman of the Competition Commission. The views in this lecture are personal and should not be attributed to the Competition Commission.

² See, for example, Ofcom, “Draft Enforcement Guidelines: Ofcom’s draft guidelines for the handling of competition complaints, and complaints and disputes concerning regulatory rules”, 6 July 2006, which make the case for progressing from regulation to ‘*ex post*’ competition enforcement.

³ For a detailed discussion of these issues see the DTI/HM Treasury report *Concurrent competition powers in sectoral regulation*, May 2006, URN 06/1244.

Thirdly, other jurisdictions' experience is giving rise to similar issues. For example, in the EU, DG Comp has recently undertaken several sector studies under Article 17 of the Modernisation Regulation.⁴ These are intended to examine sectors which appear to exhibit lack of competition to see what further intervention, either by way of competition enforcement, regulation, or de-regulation, may be appropriate. These sector inquiries open up issues that go wider than a narrow competition focus – see for example the interim results of the energy study discussed by Commissioner Neelie Kroes in a recent speech, which point to a need for merger control, other competition interventions and market liberalisation measures.⁵

III. Investigation or Prohibition? The role of the CC

The UK regulators' "concurrent" competition powers mentioned above do not only mean Article 81/82 (or Chapter I/II in the UK). A parallel means of competition enforcement is provided, in the UK at least, by the market investigation régime (MIR) contained in the Enterprise Act, and use of these powers is also available to UK regulators. (Interestingly, in the various regulatory statutes, regulators' powers under the EA to refer markets to the CC for investigation are mentioned before their powers to take enforcement action under the Competition Act).⁶

This alternative system for confronting competition issues centres round the CC. So what exactly does the CC do? The CC is essentially a Phase II Authority deciding on mergers, markets and regulatory issues. All cases are on reference from another body – the CC has no original jurisdiction. On mergers, the Office of Fair Trading (OFT) is the sole referring body on competition issues (Ministers may make references on specific public interest issues). In relation to markets, the power to refer is extended also to the principal economic regulators.⁷ On regulatory issues the CC's task is essentially to rule on licence modifications and price control reviews where there is disagreement between licensees and the regulator. Each regulatory regime has its particular features. For example, in relation to airports, the CC's involvement, for designated airports at least, is compulsory; for communications, an appeal now lies to the Competition Appeal Tribunal (CAT), which refers pricing aspects on to the CC. And for Energy Code Modifications under the 2004 *Energy Act*, there is a new process for appeal to the CC. Let us now look at how these various functions operate in more detail.

⁴ Regulation 1/2003, OJ [2003] L1/1.

⁵ Speech/06/480, 2 September 2006. Competition and regulatory concepts are also regularly combined in EU communications regulation where this must be in line with "the principles of competition law", and "significant market power" (a competition concept) triggers regulatory intervention (see Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services, OJ L 108, 24 February 2002, page 33, Article 15(1)-(3) and *Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services*, OJ 2002, C165/03, paragraph 4.

⁶ See eg *Communications Act 2003*, section 370 and similarly in the *Water Industry Act 1991*, the *Railways Act 1993*, the *Gas Act 1986* and the *Electricity Act 1989*.

⁷ ORR's power to make a Market Investigation reference to the CC derives from section 67(2A) and (2B) of the *Railways Act 1993*; GEMA's in relation to gas derives from section 36A(2A) and (2B) of the *Gas Act 1986* and, in relation to electricity, from the *Electricity Act 1989*, section 43(2A) and (2B); OFWAT's derives from section 31(2A) and (4) and section 36 of the *Water Industry Act 1991*; Ofcom's derives from section 370(1) to (3) of the *Communications Act 2003*; and the CAA's derive from section 86(2) and (4) of the *Transport Act 2000*.

IV. The UK Market Investigation Régime

The present MIR derives from the Enterprise Act 2002 which gives the CC the power, on reference from the OFT or a regulator, to investigate markets, to assess restrictions of competition and to impose remedies (if needed). Review of CC decisions is by way of judicial review by the CAT.

The CC cannot initiate a market investigation on its own. It can only investigate particular markets that the OFT (or one of the sectoral regulators) refers to it for further investigation. The purpose of market investigations is to enable the competition authorities to take an in-depth look at markets where competition is thought to be not working well, but where the problem does not at first sight appear to emanate from the dominant position of a single firm or the existence of hard core cartels.⁸ They are meant to be detailed and thorough and to apply a cure rather than a punishment. In their deployment of decision-making and remedy imposing powers they are probably unique to the UK.

The OFT and sectoral regulators are each tasked to study and observe markets to assess whether a market investigation is appropriate. There is no specific statutory basis for these studies in the Enterprise Act, and for the OFT they fall under the general function of studying the economy. As with EU sector studies, if the OFT finds that a particular market appears to be subject to restrictions of competition it must use further means to remedy them, either by the use of CA98 or Article 81/82 or by referring them to the CC for a market investigation, or by seeking assurances or formal undertakings from the parties concerned (if they are willing to offer them). For regulators, the position is a little different as they will be closely acquainted with the conditions on the markets they regulate. The question will be more one of the choice of further measures (either regulatory or competition) that are appropriate in any given situation.⁹

Adverse Effects on Competition

Although it is the successor to scale and complex monopoly investigations, the MIR relies on a new legal framework based on “adverse effects on competition” (AEC). An AEC arises where “any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom.”¹⁰ The AEC test has a considerably wider scope than Articles 81 and 82 EC (or Chapters I and II of the Competition Act 1998) and can arise from one or more of the following features of the market:¹¹

- (1) the market structure;
- (2) the conduct of suppliers or acquirers of goods or services; or
- (3) the conduct of customers.

⁸ A good summary of this is given in the Explanatory Notes to section 370 of the 2003 Communications Act.

⁹ <http://www.of.gov.uk/Business/Market+studies/cases.htm>. Such market studies by the OFT or regulators can also result in the following outcomes: (i) the market is given a clean bill of health; (ii) information is published to help consumers; (iii) firms are encouraged to take voluntary action; (iv) a consumer code of practice is recommended; (v) recommendations are made to regulators or to the Government.

¹⁰ Enterprise Act 2002, section 134(1).

¹¹ Enterprise Act 2002, section 131(2).

Conduct includes any failure to act, whether intentional or not, and any other unintentional conduct.

The reference decision

Whether to make a reference to the CC is, unlike the case for mergers, a discretion rather than a duty.¹² The hurdle is not high for exercising this discretion. As the CAT said in *Association of Convenience Stores v OFT*, “There is, if we may say so, some risk that one may mistake the height of the hurdle. ... It is a ‘reasonable ground to suspect’ test. The scheme of the Act is that a full investigation is carried out at the stage of the Competition Commission, not at the stage of the OFT.”¹³

Undertakings “in lieu” of a reference

It is open to the OFT or the sectoral regulators to accept undertakings from the parties to avoid the need for a CC reference.¹⁴ This power has not been much used so far. Undertakings were, however, accepted by Ofcom in the BT case last year.¹⁵

The threat of a CC reference can be a powerful inducement for parties to offer undertakings in lieu. Furthermore, in so far as they offer a remedy to a perceived problem in a way that minimises the investigative burden, they are very much in line with current deregulatory policy. But they cannot cure all ills and I will discuss them further later in this talk.

The Market Investigation Process

The CC has a statutory maximum of two years within which to complete a market investigation, although the aim is to complete most investigations within about 18 months (if not more quickly for an investigation with a relatively narrow focus). In the current *Groceries* investigation, the CC has indicated it will seek to make provisional findings within a year. A CC decision is final and effective, subject only to review by the CAT, as to the existence or otherwise of an AEC. Of the six investigations started since the Enterprise Act took effect, the CC has so far reached two such decisions (*Store Cards* and *Bulk Domestic LPG*), neither of which has been subject to review by the CAT.

The CC has wide-ranging powers of investigation, and is able to invite and require evidence from parties both in and outside the market under investigation. In cases referred to the CC by sector regulators, the CC would seek to treat them as a special party to the reference in order to reap the benefits of their expertise. The assistance of the relevant regulator also would be critical at the remedies stage.

The CC's procedure is highly transparent. During the investigation itself, the CC normally publishes many documents on its website and much information is shared with the parties. The CC holds many private hearings with the parties and sometimes also an open hearing, especially when there is a significant consumer interest. After publication of its provisional findings, the CC consults affected parties and will normally hold another round of hearings. CC market investigations are large

¹² Section 131(1) of the Enterprise Act states that the OFT (or a sector regulator) “may” make a reference if it has “reasonable grounds for suspecting” that an AEC exists.

¹³ Judgment of 1 November 2005. The CAT went on to consider the need for the OFT to seek undertakings in lieu.

¹⁴ Enterprise Act 2002, section 154.

¹⁵ Undertakings given by British Telecommunications Group plc to Ofcom on 22 September 2005. Undertakings were also given to OFT in relation to *Postal Franking Machines*.

and complicated processes, involving a great deal of evidence and many interested parties (for example more than 450 in *Home Credit* and 375 in *Store Cards*. *Groceries* is likely to be larger still).

Remedies

If the CC finds an AEC, it has a duty to remedy it in as comprehensive a way as possible, taking account of any consumer benefits that might thereby be put at risk.

Remedies may include recommendations for action by others, in particular to change existing legislation.¹⁶ The CC can thus make deregulatory recommendations. Critically for sector regulators, section 168 of the Enterprise Act requires the CC to have regard to the regulator's statutory functions when determining what remedial action would be reasonable and practicable, to ensure that remedies do not impinge on activities or duties of sector regulators. For this reason as well as for the benefit of their specialised expertise, the participation of any relevant regulator in the remedies assessment would be very necessary.

V. Regulatory Inquiries

The CC conducts inquiries of the major regulated industries under the relevant regulatory statutes. These inquiries fall into the following broad categories¹⁷:

- Licence modification references and references concerning non-licensable activities in the gas and electricity sectors;
- Price determination references;
- Airport references in relation to designated and non-designated airports;
- References under the Communications Act 2003.

The CC also conducts appeals in relation to energy code modifications under section 173 of the *Energy Act 2004*.

Regulatory Inquiries

Licence modifications

A regulator may modify the conditions of a regulated company's licence if the company agrees to such changes. Where a disagreement arises but the regulator nevertheless wishes to proceed, the regulator must refer the question to the CC. The question generally to be answered is whether the matter referred may be expected to operate against the public interest and, if so, whether the matter could be remedied by licence modifications.

Price determinations

In those regulated industries that review charges made by licensed service suppliers, generally at set periodic intervals, disagreements concerning the regulator's price control determination may or must be referred to the CC (depending on the relevant sectoral legislation).

¹⁶ The CC got quite close to doing this in relation to the safety régime for *Domestic LPG*.

¹⁷ See the table in CC, *General Advice and Information*, CC4, June 2003, which sets out the different types of regulatory references and the relevant statutes. There are also relevant powers under the Financial Services and Markets Act 2000, and a specific régime for water mergers.

Airports

In the airport sector, as we have seen, the CAA decides on appropriate pricing after obtaining a report from the CC. Normally these reviews take place every 5 years and are referred to as “quinquennial reviews”.

Communications

In communications pricing cases, following the Communications Act 2003, appeal lies to the CAT with pricing questions delegated to the CC. In an appeal on the merits under section 192 of the Communications Act against an Ofcom decision the CAT must refer the part of the appeal which relates to price control matters to the CC for decision within a maximum of 4 months.¹⁸

Process

The CC’s decisions in relation to regulatory inquiries answer those questions specified in the reference and those required by the relevant legislation. They generally address licence modification and price determination questions, including assessments by the CC of the cost of capital and rate of return, and are thus generally more technical and numerate in nature than other types of CC inquiries. The inquiries also are generally shorter than ones undertaken under the MIR. The last such regulatory review, a case referred to the CC by the Director General of Telecommunications in January 2002 and completed in December 2002, was in relation to *call termination charges* of the four mobile phone network operators,¹⁹ (the case was unsuccessfully challenged on judicial review.) As a remedy, the CC put forward a charge control by way of a detailed price cap formula to remedy the detriment to the public interest from the mobile phone operators’ excess termination charges.

Much of the substantive background work required for such inquiries is done by the regulators themselves prior to the reference. There is also generally extensive relevant published and unpublished material available that the CC can use for its inquiry. While this might limit the information gathering requirement, the CC still seeks further evidence and undertakes its own studies and analyses. It also makes its own determinations on questions relating to such factors as cost of capital and rate of return.

VI. Energy Code Modification Appeals

This new role derives from the 2004 Energy Act²⁰ and is an appeal mechanism against Ofgem’s decisions on modifications to Transco’s Network Code, and the electricity industry’s Balancing and Settlement Code and Connection and Use of System Code.

¹⁸ See Communications Act 2003, section 193. See also *Competition Appeal Tribunal Guide to Proceedings*, October 2005 and CC, *General Advice and Information*, CC4, June 2003, AND Enterprise Act 2002, section 168.

¹⁹ Vodafone, O2, Orange and T-Mobile, Report on references under section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed and mobile networks, December 2002.

²⁰ Section 173.

The purpose of the appeal system is to provide a fast and authoritative review by the CC of the merits of Ofgem's decisions and is therefore an instrument for appealing decisions taken by a regulator, rather than an appeal tool that the regulator can use himself.

The CC has published procedural rules²¹ to govern these appeals. The key feature of the CC's jurisdiction is that it is an appeal but, unlike other regulatory inquiries, not a re-investigation. The intention is to decide within 12 weeks of Ofgem's decision on the relevant code modification recommendation.

This appeal process is not intended to create a further tier of regulation. The CC has been given these appeal powers because it is able to oversee a quick and effective appeal mechanism. This has not yet been tested (the *Utilita Electricity* case did not proceed), but the structure is in place, and clear guidelines issued on the rules governing the process.

VII. The relationship between CC Market Investigations and Regulatory Inquiries

So what is the relationship between the CC's market investigations and its regulatory work? The trite answer is that they are done by the same body. But is there any good reason why this should be the case? To quote Sir Derek Morris, one of my distinguished predecessors, in all CC investigations, whether they be "competition" or "regulatory" ones, the CC addresses how to avoid the "exploitation of positions of market power that cannot be dealt with by the usual forces of competition."²² This focus guides the CC's work. Parliament evidently thought there was some logic in having both rôles performed by one authority, and presumably thought that the CC could contribute in both these areas, possibly addressing inter-related issues across these roles.

An early example of a case which combined these two tasks in a parallel process was the investigations into *British Gas* in 1992, which led to the separation of its trading and transportation functions. Four references were made to the MMC in 1992, two under the Gas Act and two under the Fair Trading Act 1973. There was overlapping subject matter but different remedy powers. The two reports under the FTA proposed the separation of British Gas' trading and transportation businesses. The Secretary of State (whose final decision it was) chose not to implement this recommendation, but British Gas decided to do it anyway (partly because of the onerous licence amendments put in place following the Gas Act reports).²³ 'Transco' was established as a separate unit in 1994 and the formal demerger that led to the creation of Centrica took place in February 1997.

It is possible that the same situation could occur in relation to airports. The next quinquennial review of designated airport pricing is likely to involve an investigation

²¹ *Competition Commission: The Energy Code Modification Rules*, CC 10, July 2005.

²² Sir Derek Morris, paragraph 899, in his evidence to the House of Lords Constitution Select Committee on regulatory accountability, 9 July 2003. The Select Committee's Report, *The Regulatory State: Ensuring its Accountability*, HL Paper 68, May 2004, contains a full discussion of the structure of UK regulation.

²³ The two references under the Gas Act were reported under *British Gas plc: Volume 1 of reports under the Gas Act 1986 on the conveyance and storage of gas and the fixing of tariffs for the supply of gas by British Gas plc*, August 1993. At the same time, the MMC also reported on two references under the Fair Trading Act 1973 published as *Gas: Volume 1 of reports under the Fair Trading Act 1973 on the supply within Great Britain of gas through pipes to tariff and non-tariff customers, and the supply within Great Britain of the conveyance or storage of gas by public gas suppliers*, August 1993. Two further volumes providing supporting documents were published as *Gas and British Gas plc, Volume 2 and Volume 3*, September 1993.

by the CC at the behest of the CAA some time next year. At the same time there is much speculation in the press that the CC will also be asked by the OFT to conduct a market investigation into “airports” with a view, so the media would have it, to imposing structural remedies – the splitting of airport ownership. Speculation is idle, but if that situation were to occur the CC would be faced with considering the same (or an overlapping) factual situation from both the competition and regulatory standpoints. Someone, at least, thinks this might be desirable. At the least, the CC should be able to make great use of its experience and expertise in this sector from its previous regulatory work.

VIII. Absence of references

The situation described in the previous paragraph is the exception, not the rule. Despite the CC’s powerful armoury of regulatory and competition enforcement powers, its involvement in regulated sectors in recent years has been minimal. Whatever the justification (and I will discuss this below) the fact is that regulators are not making references to the CC for market investigations nor are they or regulated companies using the CC to resolve licensing or price control issues. The nearest case was the BT undertakings in lieu²⁴ – although ORR’s current study into ROSCOs may also be relevant.²⁵ On the regulatory side, there has also been only one appeal against an Ofgem decision on an energy code modification (*Utilita Electricity*) which did not proceed and the last “proper” regulatory reference (*termination call charges*) was completed in December 2002.²⁶ From January 2000 to the present, there have, overall, only been seven regulatory references to the CC: three in the water sector (two of which were in relation to determinations of K and licence modification recommendations; and one water merger); two (compulsory) quinquennial reviews under the Airports Act 1986; one licence modification reference under the Electricity Act 1989; and the telecoms reference of mobile phone termination charges referred to above. Indeed, apart from the airports reviews pending in 2007 the position has not changed since Sir Derek gave evidence to the House of Lords in 2003.

It is only reasonable to ask why this situation has arisen. Is the prospect of a CC reference too unattractive for all concerned? Is the outcome already known and discounted? Is the delay involved in a CC too great, particularly for fast-moving industries, such as telecoms? Or is there some other explanation?

IX. Possible justifications

It may first be helpful to note the paradox of a system that depends, in part at least, for its effectiveness on the possibility of detailed review by an expert authority, yet where in practice few if any such reviews appear to occur, and where there appear to be some strong disincentives to their occurring. In no particular order, one can envisage

- The risk of delay, expense and complexity attendant on the CC’s involvement
- The possibility that the CC may have “nothing useful to add”
- Possible loss of control of the regulatory process for regulators and regulated

²⁴ See footnote 14.

²⁵ ORR, *Passenger rolling stock leasing markets – Scope of our market study and provisional timetable*, July 2006.

²⁶ See footnote 19.

- In relation to market investigations, the possibility that the CC may impose inappropriate, or ineffective, remedies having regard to the particular features of the sector.

Let us examine each of these a little more closely.

“Delay, expense and complexity”

One factor may be the perception that referring a case to the CC will involve very large delay, expense and complexity. There is, of course, some justification for this, but it is important not to overstate the point, nor to elevate it to greater importance than it merits.

On possible delay, it is true that CC investigations take time – normally 6–9 months for a licensing review case, 18 months–2 years for a market investigation. It is hard to see how the CC could do its job effectively with very much less time than this.²⁷ But CC references do not come “out of the blue”: they normally follow an intense and often lengthy period of engagement between the parties. So the CAA airports pricing review began in December 2005 (arguably earlier) and will last until 2007: against this the CC’s likely 6 to 8 months’ involvement looks quite modest. Similarly the last water review began in 2002 and lasted two years before completion by Ofwat in December 2004. This is not to say that delay is desirable – far from it. Merely that possible risk of further delay at the CC stage may not be the main issue. And for competition cases it would not be unfair to note that in comparison with many major competition investigations under other regimes, two years from start to finish looks quite reasonable.

“Nothing useful to add”

It might be suggested that the CC has explained its methodology and approach on all the main regulatory issues that are likely to arise, and a regulated sector was not needed to consult it again, as it were. As may be surmised, I do not think much of this point. Even if it were true that the last word could ever be said on issues of this kind, it would be surprising indeed if the last word had been said more than five years ago now. Times and economic climates change, as do regulatory imperatives. And it would be unwise to detach methodology from facts completely. New factual situations may require new assessments and evolution of, if not radical change to, methodologies. So I do not think that as a matter of principle the CC has nothing new to say.²⁸

“Loss of control”

This perceived risk is linked to the issue of delay and complexity, but has more to it than that. Regulatory authorities develop a profound understanding of the industries they regulate and regulated companies obviously do the same. Both may, understandably, be concerned about the involvement of a separate and only periodically involved authority that may disagree with the generally accepted and established approach. This again should not be exaggerated but it is true that, very occasionally, it does happen that the CC and regulators disagree. In the so-called

²⁷ Note the timetable for ECM Appeals is much shorter, there being much less emphasis on fact finding.

²⁸ New factors in the past five years could include changed expectations of future interest rate changes, research on equity risk premiums, and on possible alternatives or refinements to the Capital Assets Pricing Model.

“*Market Abuse*”²⁹ case Ofgem’s predecessor sought modification of generating licences to give it the power to control short term market abuse. Most licensees accepted this but two (AES and British Energy) objected, precipitating a reference to the CC. The CC disagreed with the regulator and found for the companies.

That was not a price review case as such, but then the CC does indeed not always accept the regulator’s conclusions – or vice versa – as the last airports reviews illustrate.³⁰ There the CC’s recommended approach differed markedly on one key issue (single/dual till), from that first put forward by the CAA. The CAA eventually accepted the CC’s approach but chose different price caps for Manchester and Stansted from that recommended by the CC. (The airports régime is one where the regulator is not bound by the CC’s conclusions.)³¹ However, in general, and at the risk of gross over-simplification, regulators accept the CC’s conclusions and solutions and examples of serious disagreement are relatively few.

But, one is tempted to say, the whole point of having the CC involved is to take the final decision out of the industry’s hands. That is not to say that the CC takes no account of the regulator’s previous work and conclusions or that these do not carry great weight. But the right of review, for such it is, can only work if the review has “teeth”. So if the concern is that the CC might produce the “wrong” answer from the industry position, the better view might be that the industry’s point of view is open to question.

Ineffective remedies

Finally, and specifically in relation to the market investigation power, there might be a perception that it might be difficult for the CC to construct appropriate remedies in a regulated sector because of the requirements of the regulators’ statutory duties and the sector’s characteristics. After all, it might be said, competition is only one of the considerations that regulators have to take into account.

Again I think this fear, or risk, is overstated. The CC remedies process is painstaking and careful. In *Bulk Domestic LPG*, for example, great care was taken to work out remedies that took full account of the industry’s health and safety regime. And under section 168 of the Enterprise Act, as we have seen, the CC must take into account the relevant regulatory régime and the regulator’s statutory duties when formulating remedies.

X. Loss of credibility of the threat

So I do not see these perceptions as standing up to close examination and indeed I think the risk is in the opposite direction, namely there is a risk of the CC not being seen as a credible, over-arching contributor to the regulatory system because of what is best described as under-use. I do not think that we have reached that stage yet, but it is important to make sure that it doesn’t happen.

Clearly the threat of a reference to the CC can still be effective. The BT case, involving the acceptance by Ofcom of undertakings in lieu of a market investigation relating to the separation of BT’s retail and wholesale activities, is a good example of

²⁹ AES and British Energy (2000).

³⁰ *BAA plc*, October 2002, *Manchester Airports*, December 2002 and CAA Press Releases, 28 February and 13 March 2003. See also *Northern Ireland Electricity*, March 1997.

³¹ The CC tends to disagree more frequently with regulated companies.

it working. Arguably BT must have thought that there was a risk the CC would have gone further than the restructuring accepted by Ofcom. Similarly in relation to water in 2005, it could be argued that the parties accepted a less generous settlement than some said they would have liked (although more generous than appeared at one stage likely).³²

XI. Undertakings in lieu of a reference

Before considering the possible consequences of the present situation, let us look a little more closely at undertakings in lieu of a market investigation reference. As we have said, there can be a powerful deregulatory tool, providing the desired result without the time and expense of a full investigation. They have certain drawbacks, however, in the following sense.

First, in part precisely because they are given to avoid an investigation, their foundation in full analysis may be weaker than remedies applied following a full market investigation. They therefore may lack the definitive character of a final remedy and may therefore be less “authoritative”.

Secondly, they will probably represent more of a negotiated settlement than will final remedies. This could mean that they are less far-reaching than final remedies as parties can generally be assumed to compromise in negotiation. Conversely they could be more extensive than a full investigation might produce. At the pre-reference stage it may be easier to agree something that is broader and “cruder” than what might emerge from detailed investigation.

More importantly, however, they depend for their effect on what is involved in a market investigation being clearly understood and on the threat of a reference being credible and it is to this that we now turn.

XII. The credibility of the reference threat

Settlement under the threat of a CC investigation (either in licence modification or price determination cases, or under the market investigation régime) is an important tool of enforcement. It is essentially deregulatory and avoids unnecessary delay and expenditure. As part of the enforcement spectrum it is very valuable. But its effectiveness will be in proportion to the belief of the parties to the settlement that the threat of a reference to the CC is credible and the extent to which the CC’s actions are seen as principled, expert and liable to produce an authoritative and independently based result. A CC that was for example seen as a regulator’s cipher or one that produced random decisions would not be viewed as contributing very much to the enforcement process.

But there is more to this than the parties’ perceptions of the CC and what it might do. It is necessary also to consider the position of the makers of the threat. In his seminal book *“The Strategy of Conflict”*, Thomas Schelling identified that to be credible a threat had to be efficacious and that “credibility may depend on the costs

³² See Philip Fletcher’s presentation on “Water and sewerage charges, 2005-10: Final determinations”, 2 December 2004. This notes that companies asked for average bill increases of 29% from 2004-05 to 2005-10, whereas Ofwat’s decisions resulted in a significantly lower average increase of 18%. In relation to the final price limits for 2005-10, the weighted average figure for water only companies in their final business plans was 5.5 whereas the weighted average figure in final decisions was 3.1; for water and sewerage companies, the final business plan average figure was 6.3 versus the final decision average figure of 4.3; and the industry average in the final business plan was 6.2 versus a final decision average price limit of 4.2.

and risks associated with fulfilment for the party making the threat”.³³ In other words, if the market players perceive that the referring authority sees a reference to the CC as costly and risky for itself, then the threat becomes less credible.

So in relation to regulatory inquiries all concerned must perceive that the CC’s involvement in the regulatory system is effective and useful. This suggests that regulators, the regulated, and the CC have to become parties to a tacit conspiracy to maintain the necessary degree of credibility. For its part, the CC must do its utmost to limit cost and risk – particularly risk of an arbitrary outcome. The referring authorities must give timely indications of their belief in the utility of CC references, as must, in the case of regulated sectors, the industry itself. Of course, the best solution to all these needs is for an actual reference to be made, from time to time. This, however, needs to be stated with some care and I want to make it absolutely clear that I am not in any way criticising any individual decision in any case to date. I am simply making a general observation about the state of things now and possible concerns for the future.

XIII. Conclusion

I have deliberately mixed up the discussion of licensing and pricing cases with market investigations. This is partly because of the things, substantive and procedural, that they have in common. But there is a more direct connexion that should be made. Here we come back to the need to avoid too narrow a definition of competition enforcement. I am suggesting that regulators’ market investigation powers can be just as important in particular situations as their Competition Act powers. A market investigation may legitimately follow a price review or even, as could arise in the airports cases, be in parallel. Not only are market investigations a very useful way of investigating industry-wide issues but, in terms of fairness of process, thoroughness of investigation and practicality of remedies, they can have important advantages over the so-called ‘prohibition’ system. And with a maximum of two years they are comparatively quick for what they can deliver.

So, in conclusion, I do not know what chemical is concocted from mixing regulatory “chalk” with competition “cheese”; but I have tried to show that the distinction between them is not as clear cut as some would argue and that, in particular, market investigations can act as a bridge over whatever gap divides the two. And the CC’s regulatory functions, like all complex machinery, from time to time need lubrication.

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³³ Thomas C. Schelling, “The Strategy of Conflict” (Harvard University Press: 1980 ed.), page 6.