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AUGUST 2004

Taking the bull by the horns

CARVING COMPETITIVE ADVANTAGE FROM REGULATION

The expanding role of the regulators is a feature of all modern economies. This is true not only in the "liberalised" utility sectors, such as electricity and telecommunications, but also in industries with a longer history of market competition, such as the retail trade or financial services. Whilst some businesses simply complain and comply, the savvy firm invests in understanding regulations, builds them into the business planning process and seeks to influence their evolution. In short, it tries to turn regulation into a source of competitive advantage. This bulletin describes how such firms approach this challenge.

Regulation may raise costs, change investment profiles, limit firms' freedom to set prices or alter the ways they communicate with customers. On occasions, it may completely change the nature of competition in a market. So from the businessman's perspective, it is easy to see economic regulation simply as a bundle of technical inconveniences, or obstacles to the pursuit of competitive advantage. The natural →

response is to treat regulation as a compliance issue: the business of lawyers rather than strategists, particularly since the increased threat of corporate and personal penalties has made boards more anxious to be legally armoured against infringement of regulation.

However, some businesses have come to believe in treating regulation more proactively. They seek to understand the objectives of the regulatory framework in order to live, and better still, find ways to prosper within it.

TURNING DIFFICULTIES INTO OPPORTUNITIES

From a commercial point of view, the key point about regulation is the extent to which it changes the rules governing the markets in which a firm operates. This will typically change a firm's risks and opportunities, requiring it to identify the appropriate strategic response.

Simple compliance – conforming with regulation without changing anything else – is unlikely to be the best strategy. Changes will almost certainly be required. These may be intended to "game" the new regulations (usually, to achieve some gain in the short-term), and/or to convert the new situation into a long-term relative advantage.

The key word is "relative". Economic regulation will affect all the players in a market. If one firm can deal with a regulatory constraint better than another, it may be able to gain a key competitive advantage, as the Tesco case study in our first box illustrates.

TESCO: THINKING BIG, THINKING SMALL

In the UK, supermarket retailers have become increasingly subject to regulation through planning guidelines. PPG6, which outlines the "sequential approach" to planning, has had the most significant impact. This prevents developers from building out-of-town stores unless they can demonstrate that all potential town centre and edge-of-centre locations have been considered. The effect has been to make out-of-town retail development increasingly difficult, forcing developers to examine town centre sites, which generally offer less space and entail higher costs.

This regulatory environment posed a challenge to the supermarket retailers. But Tesco has demonstrated how a forward-thinking response to regulatory change can lead to a competitive advantage. Tesco's success has been in developing a store-operating model that works for town centres. For example, Tesco has developed the Metro format for town centres and high streets. Additionally, the Express format (small stores attached to petrol stations) has been developed for convenience shopping.

Tesco responded quickly to the changing regulatory framework, invested in researching the best responses and took time to trial new formats. As a result, Tesco turned what appeared to be costly regulation into a source of competitive advantage. Improved flexibility in site acquisition has enabled it to open more space than other supermarket rivals, and has simultaneously given it a head start in the increasingly attractive convenience market.

Once such models are in place, it is possible to complete the loop from regulatory assessment to strategy assessment (pricing, product design, etc.). Companies can then begin to address the following questions.

- Which strategies can both satisfy the regulators' requirements and benefit our firm?
- Which regulations are likely to hit our rivals harder than us?
- What are the longer-term implications of regulation for our investment strategy?
- Are there specific forms of regulatory compliance that have more upside than others?

Without answers to these questions, it is difficult to engage regulators effectively. More importantly, it is impossible to know what you would want to achieve anyway. Arguing for the status quo is not always the best option.

Taking the bull by the horns

HOW TO RESPOND?

To connect regulation and competitive strategy, companies need:

- the right mind-set – companies tend to see opportunities in technology, but threats in regulation, despite the fact that either can be simultaneously a threat and an opportunity; and
- an economic model that is able to cope with changes in economic regulation, in the same way that it copes with changing cost structures or customer preferences.

The first issue is cultural. Organisations need to see their own regulatory specialists not merely as the "bearers of bad news", but as specialists with an important insight into the way their markets work. They also need involvement at the highest level. If regulation is important for the firm's success, it should be important for the management. If it is considered important to the management (is there a Board Director who reports on this?), it will get more attention in the company. More attention tends to mean more creative thinking, more innovation.

Our experience suggests almost all successful firms have some kind of economic model, but it may be relatively informal, or not widely used in the commercial departments. Making these models formal – in the sense that the key drivers of revenues and costs (including regulation) are explicitly modelled and linked together – has many benefits. One of them, obviously, is that it enables the impact of regulation to be modelled.

DON'T JUST SIT THERE

An intelligent response to regulation should, however, go beyond the need to adapt corporate strategy to an ability to influence the next set of rules. This takes more than good PR. It requires an investment in a team that is able to feel the pulse of government, monitor multiple threats (and opportunities), draw on other parts of the organisation to analyse and prioritise these, and communicate credibly on the issues with senior management.

The critical factor for success is the simultaneous achievement of internal and external credibility. This requires good economics. Without a fundamental understanding of the drivers of the business, the regulatory team will lack engagement with commercial policy-makers in the business. Without a fundamental understanding of the purposes of economic regulation, the regulatory team will not engage effectively with government policy-makers.

In the "repeated game" of engagement with government, it is important to pick targets carefully and only argue where a good economic case can be made. Government's rationale for the regulation must be responded to; it cannot simply be assumed away. A firm is also far more likely to be successful if it offers government solutions rather the problems; alternatives rather than obstacles. Statistics and economics carry more weight than anecdotes and anger (as the Camelot example in our second box illustrates).

If this all sounds easy, think whether your business could tick the following propositions:

- our regulatory team has a direct input into the economic model that we use to develop strategy;
- we monitor potential regulatory and policy changes more than two years ahead; and
- government asks for our views when developing policies that affect us.

The firms for which this is true have succeeded in building not merely a competence in regulatory economics, but a "brand" with government which identifies these firms as useful interlocutors in the design of regulation. This, in turn, helps them to open up competitive opportunities.

CAMELOT: IMPROVING THE ODDS

In July 2003, the UK Government announced a radical new approach to licensing the National Lottery. Its proposal was that the current "single licence" model, whereby the National Lottery is run by a single operator, should be replaced by a "multiple licence" model, whereby the National Lottery Commission (NLC) might offer one or more operating licences to run different parts of the lottery. By encouraging more competition, it was argued, this new approach would increase the funds generated for "good causes" (the main objective of the UK National Lottery).

No regulatory changes would take effect until the next licence round in 2009. But Camelot, the UK lottery operator, decided to engage in the debate immediately. To help its thinking, the company commissioned a report from Frontier Economics on the economic effects of the proposals (see our bulletin *Lucky numbers*, June 2004).

This report demonstrated that offering multiple licences would be a complex and risky option with no clear benefits in terms of funds raised for good causes. Indeed, competition within the market might seriously reduce the economic value of the lottery, the source of these funds. It was also highly questionable whether the multiple licence model would increase competition for the market.

The debate continues, but the concerns expressed in a recent report by the House of Commons Select Committee on Culture, Media and Sport[1] indicated the degree to which these arguments have given the policy-makers cause to reflect. By using hard economics, aligning the arguments with the Government’s own objectives and offering solutions as well as problems, Camelot has effectively engaged with government on an issue critical to its business interests.

CONCLUSIONS

Whilst many firms could once claim to be untouched by regulation, few can say this now. Regulation has risen up the order of CEOs’ greatest concerns, and there is no sign that the regulatory tide is going to turn. But our experience with clients suggests that proactive firms can spot and create strategic advantage out of regulatory changes, if they:

- fully understand the variables affecting their revenues and costs;
- understand the current regulatory framework;
- critically, are able to connect the two, in order to model the effect of regulatory changes on the business;
- are able to shape regulatory policy through credible and consistent advocacy based on sound economics; and
- are able to develop strategic thinking on the basis of regulatory changes.

A good regulatory team will have a number of functions, both external and internal to the firm. Externally, it will need a track record of consistency in the quality of its economic arguments, in order to build credibility and enable it to argue for changes in regulations with a reasonable chance of success. Internally, it must go beyond compliance to achieving a fundamental understanding of the business, the current and changing regulatory framework, and its effect on the firm’s operations. Only this level of understanding will give it the credibility to engage with senior management to ensure that strategy takes full account of regulatory risks, and makes the best use of all regulatory opportunities.

SOURCE	1. *Reform of the National Lottery, House of Commons Culture, Media and Sport Committee, Fifth Report of Session 2003-04, March 2004.*
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