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Worried about competition?

MINIMISING THE COMPETITIVE IMPACT OF REGULATION

Since September 2002, any new regulations proposed by UK government departments have had to be accompanied by assessments of their impact on competition. This obligation, intended to lead to better – and narrower – drafting of regulations, also offers businessmen a new opportunity to influence policy-making, if they can couch their arguments in the right economic language. In this bulletin we explore some of the issues involved in making and challenging such "competition assessments".

Policy-makers see regulation as a vital tool for achieving social, environmental and economic objectives without spending public money. Business, by contrast, more often sees regulation as an unnecessary and costly burden, hampering economic growth. In response to such complaints, successive governments have agreed to accompany new regulatory proposals with a variety of "impact assessments", covering everything from environmental benefits to business compliance costs. Trade associations and business groups have correspondingly learned to influence policy by analysing and debating these assessments, in an effort to restrain the growth in the regulatory burden. →

This Government believes a strong competition policy to be central to its drive to restrain prices and increase productivity. So Whitehall's latest self-imposed obligation is to publish an assessment of the extent to which any proposed regulation may damage – or, alternatively, enhance – competition. This opens up a fertile new field for debate, and a useful new opportunity for business to shape the form and extent of new regulations.

In this bulletin, we aim to provide some insights into the way competition assessments will be made, and therefore into the ways in which they can be challenged, drawing on work we have done for the Office of Fair Trading and the Department of Trade and Industry.

The first step is to avoid a common misapprehension: that "competition" is the same thing as "competitiveness". Any domestic regulation that raises the costs of doing business will be seen by British companies as damaging their competitiveness in world markets. But unless such a regulation reduces the extent to which producers have to compete for customers in those markets, it will be hard to argue that such a regulation fails this new test. Even if it drives some British producers out of the market, there may still be healthy competition between those that remain. Indeed, in markets that are truly international, and supplied by plenty of foreign producers, a domestic regulation might not damage competition even if it had the effect of destroying the competitiveness of every British producer.

DOUBLE TROUBLE

The starting-point for a competition assessment is to examine the economic effects of a proposed regulation – in terms of prices, efficiency, innovation or quality. However, as we have seen, even if one or more of these are affected, unless a regulation changes the competitive process, there is no competition concern. It is necessary to identify the circumstances in which this double effect will happen.

- **Changing costs.** A regulation might change the costs faced by firms in such a way that there would be a change in the relative size, or number, of firms and a consequent change in market structure and market power. For example, a regulation limiting the use of pesticides could raise the cost of growing a given quantity of vegetables by forcing farmers to use a more expensive method of pest control, potentially forcing some farmers to exit the market. A competition concern only arises if sufficient firms leave the market such that the market power of the remaining firms increases.
- **Restricting choice.** A regulation might restrict the choice that firms have as to how their product or service is marketed, delivered, or priced, with a consequent change in the nature of competition and/or a change in market structure and market power. Consider for example two producers of fireworks: one produces high quality expensive fireworks, while the other produces low quality inexpensive fireworks. A regulation imposing minimum safety standards could affect competition by prohibiting the sale of the low quality firework, thereby restricting the choice available to consumers in terms of the products available for purchase.
- **Creating or enhancing barriers to entry or expansion.** A regulation that has this effect might change the market power of those firms already in the market. For example, regulations that prevent suppliers other than the post office from delivering mail with a value of less than £1.00 could be argued to act as a barrier to entry.

The threshold for the competition test is therefore pretty high. We have seen that it is not enough to demonstrate that a regulation would impose extra costs. Nor, even, is it enough to demonstrate that the higher costs will drive some firms out of business – if enough remain to provide effective competition.

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The key questions are whether the effects of a new regulation would be sufficiently powerful to:

- lead to a change in either the nature or intensity of competition between suppliers; which in turn would
- have a significant effect on the welfare of UK customers.

TAKE YOUR PICK

This high threshold for the competition test explains why the majority of new regulations, however burdensome or unwelcome, are unlikely to be demonstrably harmful to competition. The key for business will therefore be to understand how to identify the kind of regulations that are most likely to be open to challenge under this new test.

The Competition Guidelines address this question by using a "competition filter" as a first step towards identifying the regulations that are most likely to affect competition¹². The guidelines offer a checklist, based on a number of straightforward questions about the structure of the affected market and the nature of the regulation. It helps to identify those regulations for which a more detailed assessment is therefore needed.

Essentially, there are four factors that will determine the likelihood that a regulation would damage competition.

- **Market structure.** If a new regulation is imposed on a market served by a small number of firms, or with one or two large firms amongst the mix, there will be a greater risk of a harmful effect on competition.
- **Scale of costs.** The larger the costs imposed by new regulations, relative to the size of the businesses affected, the more difficult it will be for all of them to cover these costs and the more likely it will be that a significant number will be driven out of the market.
- **Asymmetry.** A regulation that imposes higher costs on some firms than others will affect the extent to which those firms can compete, and might lead to an increase in market power for the less affected firms.
- **Barriers to entry.** Regulations that make it more difficult for new firms to enter a market are more likely to damage competition. This is particularly important in markets that are dominated by a few firms.

As we have seen, none of these factors may be sufficiently powerful to cause a regulation to fail the competition assessment. But this approach can help to identify those regulations most open to challenge.

STEP BY STEP

There are a few simple steps businesses can take in order to take effective action to influence the design or consultation stage. They need to be armed with a clear understanding of:

- the definition of their market (local, national, European, global);
- the structure of their market (the size and market shares of all the players);
- the type of regulation likely to be imposed (eg, whether it will restrict freedom of action or raise costs);
- the scale of its likely impact relative to the size of the businesses involved; and, importantly
- the cumulative impact of all regulations, including existing ones.

Even if an individual regulation does not give rise to a competition concern, it might

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be the case that the combination of a series of regulations would do so. Suppose, for example, that there has been a series of regulations that each raised production costs by a small amount, but did so asymmetrically. While no individual regulation might be significant enough to fail the competition test, the cumulative effect might well do so – and officials can be urged to examine the overall impact of regulatory action.

FIND ANOTHER WAY

If a proposed regulation can be demonstrated to have an adverse effect on competition, policy-makers have two options.

- Firstly, they can seek to achieve their objectives by another route – for example, substituting market-based incentives to "good behaviour" rather than imposing obligatory rules. Consider, for example, proposals to ban tobacco advertising. Given the importance of brand in the tobacco industry, it is possible that this restriction could have a detrimental effect on competition. Were this to be the case, policy-makers might try to achieve the same objective – reducing the number of people who smoke – either through an increase in the level of taxation placed on tobacco, or through an increase in the funding devoted to raising awareness of the health risks associated with smoking.
- Alternatively, they can decide that the benefits of regulation outweigh the economic costs of reduced competition.

Either of these options offers an opportunity to business to engage and influence the outcome. Companies or trade associations may be able to deploy their understanding of industries and markets to suggest preferable ways of achieving policy objectives, or to engage in the cost-benefit analysis that may have to follow a competition assessment. Since such assessments have to be made in advance, there will inevitably be a good deal of debate as to the likely scale of the damage to competition a regulation would cause, and hence its economic cost. Well-briefed businesses should be able to engage effectively in such a debate.

CONCLUSION

The new competition assessments should help to improve regulation. They may lead to better and more tightly-defined regulations with fewer unintended economic consequences. They also provide firms with the opportunity to feed economic arguments into the consultation process, and thereby influence the scope and scale of regulations. In order for firms to do this effectively, they need to build an understanding both of how regulations can lead to competition concerns in general, and more specifically, of how regulation may affect competition in their own industry.

SOURCE	<ol style="list-style-type: none"> 1. <i>OFT, 2002, Guidelines for Competition Assessment</i> 2. <i>Frontier Economics helped the OFT to draft the Guidelines for Competition Assessment.</i>
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