Bulletin

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Faster, better, cheaper?

CHALLENGES FOR THE UK'S NEW COMPETITION AUTHORITY

*In April 2014 the UK's new Competition and Markets Authority (CMA) took over responsibility from the now-defunct Office of Fair Trading and Competition Commission. This bulletin reflects on the Competition Commission's approach to Phase 2 market investigations over the past decade, identifying some important challenges for the CMA as it picks up the baton and embarks on its high profile Phase 2 investigation into the GB energy retail market.**

Until April this year, the UK market investigations regime involved two separate authorities, the Office of Fair Trading (OFT) and the Competition Commission (CC). The OFT was responsible for the first, or "Phase 1", look at competition issues arising in a market, and the CC for the deeper "Phase 2" market investigation of those issues handed on to it by the OFT. The 2002 Enterprise Act enhanced the information-gathering powers of both OFT and CC, and gave the CC powers to impose stringent remedies, should it find evidence - at the end

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of its Phase 2 investigations – of competition failing to work effectively. The CMA merges the OFT and CC into a single authority, but the CMA will inherit the legal framework for market investigations largely untouched. The CMA can therefore be expected to build on the experience accumulated by the CC.

Over the past ten years, the CC has undertaken Phase 2 investigations into 16 markets, ranging from the high-profile (*Groceries* and *Audit*) to the quite obscure (*Domestic Bulk Liquefied Petroleum Gas* and *Rolling Stock Leasing*). In all but one case, the CC found evidence of competition not working effectively and required remedies to be put in place. Expectations are high in relation to the CMA's approach, not least because its first Phase 2 investigation will be a highly-charged investigation into the retail energy market.

Being investigated is clearly not to be taken lightly. Most participants would say that the process has become more burdensome in recent years, and remedies more intrusive, as the CC has aimed for greater sophistication in its analysis, and sought remedies that would deliver lasting change. The new regime will certainly build on this experience, although the imposition of a more rigid timetable for investigations (see below) should improve the CMA's focus.

STARTING FROM WHERE?

In the UK, the investigating authority must identify "*whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition…*".[i] It can do this through a combination of discovery (reviewing the documents and data of firms in the market); hearings (with both these firms and third parties); and analysis (its own detailed empirical work).

The past ten years have seen a tendency towards more exhaustive document review (including the use of powers to require vast quantities of emails to be supplied), more extensive data requests, and more sophisticated empirical analysis. At the same time, remedies have got tougher. In early investigations (such as *Northern Ireland Banking* and *Store Cards*), remedies were focused on giving customers more information, and removing switching costs. More recently, divestments have been imposed: the CC required BAA to sell three of its airports, Lafarge to sell a cement plant and, most recently, HCA to sell at least one London hospital.

These two developments – more analysis and stronger remedies – went hand-in-hand. To justify market-changing remedies, the CC had to present robust evidence, capable of withstanding appeal, that the benefits associated with specific remedies outweighed any associated costs for consumers. Where the CC was not, initially, sufficiently rigorous, it suffered two successful appeals against its findings to the Competition Appeals Tribunal (CAT).

Two types of analysis have been particularly influential on the outcomes of recent CC inquiries.

- **Performance Concentration Analysis (PCA)** is now commonly used in market investigations that deal with multiple product or geographic markets (for instance, *Groceries*, *Local Bus Services* and *Aggregates, Cement and Ready Mix Concrete*). This analysis seeks to determine whether there is a relationship between profit margins (or other measures of performance) and local/product market concentration. If this relationship is positive (i.e., firms in concentrated markets make higher margins) and statistically significant, that has been taken by the CC to be a strong argument for remedial action. However, this technique is controversial, as it can be hard to determine statistically whether high margins are caused by concentration or other factors. Attempts to resolve this problem – such as the use of "instrumental variables" – are technically complex and can give misleading results. These analyses can be a "black box" to all but experienced econometricians – and they can quite often have professional differences of view – but nonetheless are often highly influential.

- **Profitability analysis,** long part of market investigations (as in, for instance, *Classified Directory Advertising Services* and *Home Credit*), has become increasingly important. Moreover, the hurdle rate for profits to be deemed excessive has been lowered. Previously, the test was whether the economic Return on Capital Employed (ROCE) was significantly and persistently above the Weighted Average Cost of Capital (WACC) across most of the market. More recently, however (as in *Local Bus Services),* the CC has deemed profits to be excessive if economic ROCE exceeded the WACC when averaged over a five-year period, even if profits were "normal" in some years. But again, as with PCA, there are difficult issues arising in the calculation of economic profit. To measure economic profits it is necessary to have an up-to-date valuation of each firm's assets - debatable if they were acquired some time ago. And valuing intangibles, such as customer bases or brands, is particularly challenging. Yet only in the *Northern Ireland Banking* and *Audit* investigations did the CC decide that the results of a profitability analysis would be too imperfect to inform its findings.

Recently, the CC has used "data rooms" as a method to share data and analysis, not only relating to PCA and profitability analysis but also other empirical work (as, for example, in the *Private Healthcare* investigation). The greater reliance on empirical analysis by the CC has necessitated this step to ensure that the parties were able to review and comment. Data rooms enabled the parties' advisers to do so. In addition, in certain investigations (for example, *Groceries* and *Aggregates)* the CC appointed an independent expert to review aspects of its analytical work.

A final notable development has been the use (for example, in *Local Bus Services)* of round table discussions of the empirical analysis between CC Panel Members and the main parties. The primary aim was to flush out inconsistencies between the positions of the main parties and third parties, and to identify areas of weakness in the analysis on which findings would depend.

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BE PREPARED

Investigations have always demanded attention from senior management and product/finance teams. Recently, however, meeting CC requests has required more work, not merely to extract the data demanded, but also to understand it, check it, clean it and perhaps reformat it.

The CC has in theory been keen to avoid making requests with no clear link to its theories of harm – and the publication of these theories, an innovation of the past decade, has provided some welcome guidance. So when requests (which could not of course be refused) seemed exceptionally expansive, it was worth querying the link; and this will continue to be true now the CMA is in charge.

Senior management can find it hard to engage with empirical analysis, often undertaken on unfamiliar data and using still less familiar statistical techniques. This is a challenge the CC (and in future the CMA) has had to share, since findings need to be given in a form to which the parties can properly respond. Round tables were a way of creating more transparency and opportunity for questions; but the inherent complexity of the analysis remains a problem.

SO NOW WHAT?

The UK market investigation regime that the CMA has inherited remains, for the most part, unchanged. While both Phase 1 and Phase 2 will be carried out by the same institution, and there will be some attempt to avoid duplication, Phase 2 investigations and remedies are likely to follow a similar approach. In our view, therefore, the most critical issues for the CMA are as follows.

- **Ensuring that the parties are able to comment** on the arguments and evidence upon which the CMA intends to rely. The new authority will need to ground its analysis in a proper appreciation of the parties' businesses, in order to articulate its theories of harm, and the relevance of its analysis, in a way that can easily be understood. The CMA will also need to set up data rooms in such a way that the parties have a genuine opportunity to engage with the analysis, whilst maintaining confidentiality. In *Private Healthcare,* the restrictions placed on advisers working in the data rooms limited their ability to respond adequately to the CC's analysis, resulting in an appeal to the CAT; the CMA will need to adjust its processes accordingly to balance these issues.

- **Obtaining proper scrutiny** of the CMA's technical analysis. Independent reviews commissioned by the CC are a welcome development, but were not always embarked on in an open way, limiting visibility of the full assessment made by the expert. A more open process for engaging independent experts would enhance confidence.

- **Learning from past cases** about the choice of remedies**.** The trend towards more intrusive remedies raises the question as to whether less costly

alternatives have been sought and considered. The CMA needs to be alert to its legal responsibilities in this regard, or face the prospect of appeals such as those against the remedies proposed in both the *Aggregates* and *Private Healthcare* investigations.

- **Striking the right balance** between the depth of analysis, the consequent costs of data collection, cleaning and review, and the efficacy of remedies. The CMA has to carry out a cost-benefit analysis of the remedies it is considering, and may only impose them if the results are positive. It is not required to consider the costs to businesses associated with an investigation; however, it would be good if the CMA were to show it was mindful of these.

CONCLUSION

That key final point that "more analysis is not always better" is reinforced by the new timetable. The CMA must complete a Phase 2 investigation within 18 months; extensions will be allowed only in exceptional circumstances. By comparison, in recent cases the CC rarely issued its final report much before its 24-month deadline. The level of detailed analysis conducted in past cases might simply not be possible for the CMA, requiring it to have greater focus and prioritise better. That could well deliver benefits all round.

** Frontier has advised or is advising clients in 14 of the 17 market investigations under the Enterprise Act.*

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[i] This was the statutory test used for assessing competition issues for market investigations undertaken under the Enterprise Act 2002. The same test has been retained in the Enterprise and Regulatory Reform Act 2013

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