Professor Paul A. Grout*

Response to

Competition and Markets Authority (CMA) Regulated Industries: Guidance on concurrent application of competition law to regulated industries (Consultation Document)

This response concerns Questions 1 and 2 of the consultation. Using the terminology of the questions, I believe that the transition team's approaches are not appropriate, for reasons explained below.

The bulk of the response is an amended extract from my short paper 'Making Concurrency Work', which explains my reservations with the current approach being implemented in the UK.

To briefly summarise, the extract points out:

(a) that if there is an inherent disposition for regulatory agencies to be, or to become over time, robust rather than captured then some preference for turning to the licence enforcement powers rather than the Competition Act to deal with potential abuse and market failings is to be expected and is unlikely to be a temporary phenomena.

(b) ERRA 13 and the processes suggested by the CMA's transition team do not sufficiently with the problem since

(i) the 'more appropriate' test and the annual review are unlikely to be strong enough to resolve the issue and

(ii) the 'use or lose' powers of the CMA may result in outcomes that are worse than the problem they are designed to solve.

The extract suggests the following alternatives:

Alternative A.
In each of the relevant regulatory sectors, the regulator must seek ex-ante CMA approval if licence enforcement powers are to be used instead of CA98. The CMA could identify a set of case characteristics, regulator specific, such that any case within this set requires this ex-ante approval. This could be implemented by setting up a committee within the CMA to hear the regulator's proposed justification for using licence enforcement powers and for the committee to make a judgement either to agree or to request that the regulator uses CA98. In an ideal world it would be beneficial if the CMA could force the regulator to use CA98 even when the regulator preferred to use licence enforcement powers.

.
Alternative B:
An alternative could be to resort to Alternative A if a regulator's performance was deemed problematic in terms of the regulator's use of CA98. This would appear to be less dramatic that a nuclear option of removing the regulators concurrent powers (hence more likely to be implemented) and preserves the likelihood of CA98 cases being undertaken in the best arena.

The extract is taken from an academic paper considering alternative solutions that could have been followed in UK. The difficulty given the limitations of the current consultation is that it is not clear how close it is possible to get under the current proposals to something such as Alternative A, without explicitly taking the case from the regulator. Perhaps putting some of the suggested committee's ex-ante opinion into the public domain could go some way towards bringing pressure on regulators without actually forcing their hand

* Professor Grout is Professor of Political Economy at the University of Bristol and a non-executive director of Ofgem. This response is a personal opinion and in no manner should be seen as representing views of the University of Bristol or Ofgem.

AMENDED EXTRACT

Is there an innate problem?

A common model of regulatory agencies frequently discussed in the US context is the notion of regulatory capture. However, there is evidence that in many areas of regulation, notably independent regulatory agencies, the situation is likely to be the opposite. That is, regulators can be described as being robust in their treatment of companies that they are regulating rather than being captured. Furthermore, this may be a generic feature rather than a modern (potentially) temporary situation.

This preference for robust treatment of companies appears to be present from the early days of utility regulation. For example, Section 2 of Grout, Jenkins and Zalewska (2013) investigates the Supreme Court cases surrounding the development of the rate of return model of regulation in the US between the Smyth v Ames 1898 (which initiated the notion of fair value) and the Hope Case 1944 which put in place the standard US rate of return model that dominated US regulation for the remainder of the century.[1] During this period the regulatory model was being developed case by case and the preferred approaches of regulatory agencies switched between using original cost and replacement cost at different points. However, far from being random, the preference for original cost or replacement cost can be predicted (with 1% significance) by the past history of capital goods prices. Essentially when replacement cost is high relative to original cost a regulatory agency is far more likely to opt for original cost than replacement cost and vice-versa. So far from being captured the evidence is that regulators are displaying a marked preference for the solution that gives the lowest asset base and hence the lowest short term consumer prices.

In a more recent context Garside, Grout and Zalewska (2012) investigates the impact of the experience (as measured by number of cases previously chaired) of the chair of an investigative panel within the UK Competition Commission on the likelihood of a finding that the activity investigated is deemed to have operated against the public interest.[2] The evidence in the raw data (drawn from cases conducted by the MMC and CC over the period 1970 and 2003) shows that once experience gets large enough an activity under investigation in a case is always found to be against the public interest. Indeed, in every case with a chairman of experience of 21 or more an activity is found to operate against the public interest. Garside, Grout and Zalewska (2012) analyse this data and show that the relationship between experience and 'guilty' findings cannot be explained by differences in attitudes of chairmen (e.g., tougher chairman choosing to remain in position longer and hence building up greater experience) nor case allocation to particular chairman (e.g., allocating cases with a higher than average expectation of a 'guilty' finding being allocated to more experienced a more chairman).

[1] Grout, Jenkins and Zalewska, 'Regulatory valuation of public utilities: A case study of the 20th century' *Business History* (2013, forthcoming).
[2] Garside, Grout and Zalewska, 'Does experience make you 'tougher'?: Evidence from Competition Law', *Economic Journal*, 2012.

If there is an inherent disposition for regulatory agencies to be, or to become over time, robust rather than captured then some preference for turning to licence enforcement powers rather than the Competition Act, CA98, to deal with potential abuse and market failings is to be expected and is unlikely to be a temporary phenomena.

Changes in Enterprise and Regulatory Reform Act 2013

Recognising the historical problem, the Enterprise and Regulatory Reform Act 2013 (ERRA13) is introducing changes to the implementation of the concurrency regime.

In particular:

A: regulators will be required to consider whether the use of their CA98 powers is more appropriate before using their licence enforcement powers

B: regulators will be required to report annually the CMA on the use of concurrent powers in the regulated sectors

C: competition authorities can enter into arrangements to share more information about possible antitrust cases and case management decisions

D: the CMA will be given the power to decide which body should lead on a case

E: the CMA will be given the power to take over a case from a regulator, even if a regulator is already started an investigation.

Taken together the new processes appear to have three main types of mechanisms that address the problem of the imbalance between use of the licence enforcement powers and the CA98 by regulators. These are:

(i) potentially more careful justification for use of licence enforcement powers through the requirement of a 'more appropriate' test before the CA98 is put to one side,

(ii) a formal arena for the CMA to evaluate (and feedback on) a regulator's performance over time through the annual report to the CMA and greater information sharing more generally

(iii) a formal control mechanism through the ability of the CMA to allocate cases between regulatory agencies and, more significantly, to take cases from a regulator, i.e., essentially a 'use or lose' censure mechanism.

Problems with these proposals

While these processes may lead to a different balance between regulator's use of the licence enforcement powers and CA98 there are several reasons to think that they may not be sufficient or the best approach to tackling the problem.

The 'more appropriate' test may force regulators to be more careful in their justification for using licence enforcement powers over CA98. However, the decision remains within the regulatory agency and is it is not clear how this will remove any existing bias if the bias is itself a reflection of genuinely held beliefs of the regulator as to what is necessary to 'get the job done'. The evaluation procedure ((ii) above) may help to expose perceived bias and feedback from the CMA may serve as suasion on a regulator but this is an indirect tool and the time scale of change through this mechanism could potentially be long.

A test 'not to use Broadcasting Act powers for a competition purpose, where they consider that a more appropriate way of proceeding would be through the use of their general competition powers under the Competition Act 1998' has been placed on Ofcom since CA2003 but cases such as Ofcom's Pay TV decision against Sky (rejected by the CAT) have been conducted through licence enforcement powers rather than CA98. In contrast, no such obligation sat with Ofgem, yet Ofgem successfully enforced a large CA98 case against National Grid for abusing its dominant position in the provision of domestic-size gas meters (NG appeal rejected by the CAT) Hence, although a 'more appropriate' test may be helpful it alone is unlikely to bring about a significant change.

The 'use or lose' rules appear to be the big potential 'game changer' here but there are several reasons why this may not be ideal.

One is that there may actually be a perverse effect with damaging long term implications. The introduction of strong 'use or lose' pressure on regulators could create a climate where regulators feel obliged to run cases simply to display their willingness to use the CA98. If several regulators move quickly and pursue multiple cases then this will itself create more pressure on other regulators. So bizarrely it is possible that the 'use or lose' approach may lead to a significant jump in cases, some of which may be ill conceived. That is, we could end up with a mini-bubble of cases. While this may display the required enthusiasm to run with CA98 cases, ill-conceived cases are less likely to survive appeal to the CAT. Therefore, a consequence of the introduction of a 'use or lose' censure mechanism could be a significant failure rate of cases, which could re-enforce any original bias against using CA98 instead of the licence enforcement powers.

Second, there is no suggestion that the regulators are the wrong agencies to be undertaking CA98 cases. Of course, there are so few infringement decisions that it is hard to know how well placed this view is and it remains to some extent an act of faith. However, the Ofgem/National Grid case mentioned above was undertaken successfully and fully survived appeal to the CAT, save for a reduction in fine. Hence the view that regulator's special skills are needed (or at least beneficial) to apply CA98 still appears to hold force. But, if this is so, then the solution to a regulator's overly infrequent use CA98 appears the wrong one. The transfer of cases to the CMA is not really the solution. Indeed, it is an open question whether the CMA undertaking a CA98 case is better or worse than a regulator using licence enforcement powers to

undertake a case that would be better dealt with using CA98. We are essentially comparing two inferior outcomes to the best solution which would be the regulator's use of CA98. If the case has many complex industry specific aspects then a regulator using licence enforcement powers may be better than the CMA using CA98. On the other hand, if there are few complex specifics then use of CA98 by the CMA may be better than the regulator using licence enforcement powers when the regulator should have used CA98. The general point is that the solution to the bias against use of CA98 by regulators may be worse than the current situation.

Third, taking concurrency away from a regulator is probably viewed as the 'nuclear option' and to be used as a very last resort. This may, of course, mitigate against the two problems identified above since the threat may be seen as relatively empty, but if it is perceived as such then hope of making a big change is not strong.

Alternatives

The two core problems I believe arise from the current arrangements can be roughly summarised as (i) the 'more appropriate' test and the annual review are unlikely to be strong enough to resolve the issue and (ii) the 'use or lose' powers of the CMA may result in outcomes that are worse than the problem they are designed to solve. A better solution would be one that focuses somehow on ensuring that regulators use the appropriate enforcement procedure on a case by case basis, rather than removing them from the regulator.

I suggest a better alternative would be one of the following:

Alternative A.

> In each of the relevant regulatory sectors, the regulator must seek ex-ante CMA approval if licence enforcement powers are to be used instead of CA98. The CMA could identify a set of case characteristics, regulator specific, such that any case within this set requires this ex-ante approval. This could be implemented by setting up a committee within the CMA to hear the regulator's proposed justification for using licence enforcement powers and for the committee to make a judgement either to agree or to request that the regulator uses CA98. In an ideal world it would be beneficial if the CMA could force the regulator to use CA98 even when the regulator preferred to use licence enforcement powers.

.
Alternative B:

> An alternative could be to resort to Alternative A if a regulator's performance was deemed problematic in terms of the regulator's use of CA98. This would appear to be less dramatic that a nuclear option of removing the regulators powers (hence more likely to be implemented) and preserves CA98 cases being undertaken in the best arena.