Agenda
Advancing economics in business

No more Mr Nice Guy: 25 years of reforming competition and regulation rules

In the early 1980s competition law in the UK was of limited effectiveness, but was still used as the model for enforcing the new rules for utility regulation. Since that time both competition law and regulatory enforcement have been reformed, learning from each other (as well as from the EU). Fod Barnes, Oxera Principal, offers an idiosyncratic view of the processes of reform

From 'I say, old chap, don't do that again', to 'That will be £10m, go straight to jail and do not pass Go.'

In 1984 (and just out of short trousers) I was forced to read, and understand, the Telecommunications Bill as it wound its way through Parliament. One of the more striking aspects of the Bill (and, indeed, the subsequent Act) concerned the provisions for the enforcement of licence provisions. On enquiry to my learned friends, I was informed that these were based on the provisions that enforced UK competition law as it then stood, so any attempts to try to change them were doomed. (Remember, BT was being privatised because the government could not afford to underwrite the investment needed for electronic exchanges, not because it was thought that good regulation might be useful to make monopolies work better.) This was not what the (budding) consumer champion, keen to stamp his mark on the privatisation legislation, wanted to hear …

What was so striking about the process? Well, it went something like this.

1. Create an obligation on BT through the licence, then …
2. require the regulator to notice that the obligation was not met;
3. consult BT about the issue—unless it is extremely bad—and give it a chance to reform;
4. issue a provisional order requiring it to do a specific thing to rectify the licence breach;
5. wait until it responds to the provisional order, and if it doesn't mend its ways …
6. confirm the provisional order requiring it to do something;


Fod Barnes, Oxera Principal

7. wait until it doesn't do it;
8. apply to the courts to enforce the final order;
9. wait until they don't; and
10. let the courts fine BT for contempt of court.

If, as a competitor or a customer, you happened to be damaged by BT's failure, then if the process got to step 6 you might just have been able to take action against BT for damages. However, prior to that step, BT had no obligations to third parties. And, as the description above makes clear, the potential penalty up to step 8 was either non-existent (up to stage 5) or minimal (stages 6 to 8).

So is this really a true reflection of how competition law then worked? Not *exactly*, but in general it is a fairly accurate picture. There was the Restrictive Trade Practices Act 1976, but most commentators assumed that any business with reasonable intelligence could avoid the letter of the law and still enter into restrictive agreements with its competitors. The Competition Act 1980 and the Fair Trading Act 1973 also played their

The views expressed in this article are those of the author.

part, but the process of getting from carrying out some kind of anti-competitive behaviour to actually suffering some kind of penalty was long, involving the Director General of Fair Trading making an investigation, the Mergers and Monopolies Commission making another, and the Secretary of State deciding that you really ought to stop. They might then issue an order and, if you failed to abide by it, you might just face civil proceedings for damages and, just possibly, the Secretary of State might apply to the courts to make you stop. At almost any point along the way, you could agree to stop the anti-competitive behaviour and everyone would go home happy (except for your competitors and consumers).

Not, perhaps, the best form of incentive regulation.

The state of UK competition law was not good, but there was substantial resistance to changing it. The USA had criminal and civil sanctions (including triple damages), but these just led to endless litigation, and really we were much better behaved over here. As for Europe, well we didn't trade much with them so their competition laws didn't really apply, and anyway these rules were not really suitable for domestic markets. Hence the rather odd idea in the privatised utilities that they would behave well and abide by their licence conditions just as long as they were asked nicely and knew what they needed to do. The role of the Director General was really just to tell them (nicely) exactly what they had to do, if they could not work this out for themselves from the pages and pages of instructions that made up the licence.

The power of demonstration

The real eye-opener came in the early 1990s with the experience of watching BT and others react completely differently to a missive from the regulator, Oftel (with respect to a complaint about a licence breach), and a similar type of missive from the European Commission (with respect to an Article 81 or 82 breach, then Article 85 or 86). There was no contest—one caused an immediate reaction, production of information and a general sharpening-up of the analysis of the offending behaviour, while the other was put in the pending tray for another day.

It became clear to many in regulation that the benefits of incentive economic regulation (the application of the RPI – X-type price controls) could also be applied more widely to competition rules and licence conditions. It was not that firms did not know what to do and needed to be told (although they protested that it was all so uncertain), it was because they didn't want to abide by their licence conditions, and they had no incentive to do so. The conclusion was that, with the right incentive (or, indeed, any incentive), ongoing compliance should be much improved. The companies actually did know what they had to do, although they protested loudly otherwise, and even if they genuinely didn't, this could be fairly taken into account in fixing any penalty.

The hard part was to invent a way of creating that incentive, given the lack of a suitable model in domestic law.

Innovation (or lack of)

A number of ideas were taken forward, and then quashed by my learned friends.

One early idea was simply to issue an order requiring BT to comply with its licence. At a stroke, BT would face penalties for any subsequent breach of the licence. However, this was not considered to be justified—you could not issue an order unless you had reason to believe that a specific breach of the licence was occurring, or had occurred and was likely to occur again. Simply knowing that BT had breached its licence, and would be likely to do so in the future, was not enough. In any case, the regulator had to specify what the regulatee needed to do in order to stop breaching the licence. So it was not actually possible to issue an order that just said stop breaching X condition of the licence. As indicated, licensees could not be expected to be able to work out for themselves what the licence actually meant, but needed to be told exactly what they should do (just as the 1980 Competition Act did not require firms to work out in advance what might constitute anti-competitive behaviour).

This generated some interesting complaints from the regulated companies as the discussion on how to get some kind of direct compliance incentive in place continued. The argument ran that it could not possibly be fair to regulated companies to expect them to face a direct penalty if they did not comply with licence conditions when they did not know what would be acceptable to the regulator. They were constantly at risk from the regulator suddenly deciding that something quite legitimate was a breach of the licence. Furthermore, unlike competition law, there was no case law to give them guidance (and in any case, the regulator was not bound by precedent). So not only was the licence enforcement ineffective, it was also uncertain and unpredictable. This was unlike European competition law, to which many firms were subject for at least some of their activities, because the impact on trade between Member States was quite a low hurdle.

So a more successful idea was tried: import competition law into the licence. Not UK competition law (which was then still ineffective) but European competition law, of

which the regulated companies had experience and claimed they understood. In addition there was some case law, so they could not complain about the uncertainty of the rules and capricious regulators. The result in 1996 was the Fair Trading Condition in BT's telecommunications licence (and in 1997 in all telecommunications licences).

The reality was perhaps not quite what the regulated companies had in mind when they embarked on this line of argument about not being able to predict what the regulator required. Rather than fairly detailed conditions which, like the Restrictive Trade Practices Act, could often be circumvented by close attention to the letter of the condition, there were instead rather broad—and, being honest, quite vague when applied to telecommunications, notwithstanding case law—requirements relating to abuse of a dominant position and anti-competitive agreements. The reality was that it was probably easier to predict what was actually required under the detailed rules, rather than under the Article 81 and 82 wording of the Fair Trading Condition. However, the problem of enforcement and incentives remained—the substance of the requirement was the same as European competition law, but the enforcement still involved at least six steps before any real penalty was incurred.

Another bright idea was to try to get the regulator the power to directly apply European law in the UK. With the *trade between Member States* threshold being quite low, this would start to really impinge on domestic regulation. Mirroring conditions in the licence would mean that the same test would be applied to the behaviour both in the purely domestic arena and in the direct application of the law in the European arena. All of this would be done by a regulator with, by now, a very good and detailed understanding of what was going on.

However, this particular wheeze was overtaken by larger changes in the UK regime.

Real reform

As a combined result of the pressure from regulators to make the enforcement structures in regulation work better, the clear failings in UK competition law, and a recognition that making the UK economy efficient through competition would deliver benefits, the reform of competition law itself moved up the political agenda. Both the technical ('it doesn't work') and the political ('it should work better') elements for reform were in place. (Although it took a long time, some reform was first mooted as early as 1989, but nothing really started to happen until 1996.) The result was the Competition Act 1998, which imported the European rules and, by also importing the enforcement structures, critically changed the incentives by making compliance with the rules directly subject to fines and actions for civil damages. The main economic regulators were also granted concurrent powers, so now they had the general competition rules to apply, and the means to enforce them much more efficiently. However, the more detailed licence rules still had the old, no incentive to comply, enforcement mechanism.

(Even under the new law, the old ways did not disappear overnight. How to design the process of enforcement of the new law often seemed to come ahead of making sure that the *content* of new law was effectively applied.)

Competition law had thus leapfrogged economic regulation in terms of creating the right incentive structures for undertakings to abide by the rules from day one (ie, do it right first time) rather than wait to be caught by the regulatory or competition policeman. This created an odd contradiction in how regulatory and competition rules are usually considered. Competition law, which is characterised as being ex post, is actually enforceable against behaviour taking place before it is discovered (ie, ex ante), while regulatory rules, which are characterised as being ex ante, could only be enforced against behaviour that continues to occur sometime after it is first discovered (ie, ex post).

Since the new Competition Act, this anomaly has been addressed in some areas, and regulators have slowly been acquiring the same kinds of enforcement structures, although in a fairly piecemeal fashion, for their specific rules.

In 25 years, therefore, the relationship between UK competition law and UK regulation has come almost full circle. Regulation, built on a model of ineffective competition law, demonstrated the weakness of the UK competition law, helping to pave the way for its very serious reform. But this reform did not include the regulatory rule enforcement structure. The new competition law then paved the way to reform the regulatory enforcement structures (by demonstrating that enforcement incentives work). Many regulatory rules can now be enforced against the first breach, and third-party damages can also arise from the initial breach. However, there is still some reluctance to really address the issue head on. But, with a bit of luck, the two structures will be more or less brought back together again soon.

Have these reforms made a difference?

In my experience the short answer is yes, although I now tend to see the process from the other side. Compared with 25 years ago, companies take possible competition law contraventions and breaches of licence conditions (or their equivalent) much more seriously. There is even evidence that firms now try to ensure, in advance, that what they are about to do will comply with the rules, rather than go over the boundary and see if anyone notices.

The enforcers have also had to change, but perhaps not quite quickly enough. No longer is it really adequate merely to ensure that the process works. The outcome is now much more serious for the companies involved, and they tend to have both the means and the incentive to fight back. So enforcers have had to sharpen up their act in ways that they might not have anticipated.

As long as the rules are right (or at least mostly right), this must be a good thing. There are still arguments about whether the rules *are* right, both in competition and regulation, and quite major reforms are possible. However, no one now seriously suggests that enforcement of competition law or regulatory rules should be undertaken on the basis that the 'good chaps' that run our industry are asked (nicely) to conform to the rules.

Fod specialises in public policy and economic issues surrounding regulation and competition—in particular, those raised by the introduction of competition into networked industries.

Over the past 25 years, he has been variously a writer for *Which?* magazine, Head of Public Affairs at the National Consumer Council, Policy Adviser to all Director Generals of Telecommunications, Chairman's Adviser for the Cruickshank Review, and is now Principal at Oxera.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

Other articles in the July issue of *Agenda* include:

- **adrift? regulating offshore electricity transmission networks**
- **spoilt for choice: consumer decision-making and the optimal market outcome**
- **valuing intangible assets: a tangible improvement to competition policy?**

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com