

Memorandum by Slaughter and May

Introduction and Summary

1. This submission is made by the Competition and Regulatory Group at Slaughter and May, one of the major UK commercial law firms. The Group, and indeed the firm generally, encounters the regulators named in the Call for Evidence on a daily basis in the course of its practice: the Office of Fair Trading (“OFT”) and Competition Commission (“CC”), in particular, in the context of merger control, Competition Act 1998 (“CA98”) cases and Enterprise Act 2002 (“EA02”) market investigations; and the sectoral regulators in the context of both their regulatory functions and their competition powers.¹
2. We note that the Committee intends to look at other international regulatory models. We do not consider these, or the many other bodies with economic regulatory functions which are not included in the Committee’s list, including the EC Commission and Government departments. We are happy to provide evidence on these if the Committee wishes.
3. The observations we make are based on the experience gained from our work representing our clients, which include not only regulated companies but also Government and other public bodies and the regulators themselves. However, the views expressed are our own. They are designed to suggest areas to which the Committee might direct its attention, rather than to identify specific solutions.
4. The principal areas which we consider merit attention include the following.
 - The level of scrutiny applied by the OFT to merger and CA98 cases as a result of previous findings of the Competition Appeal Tribunal (“CAT”).
 - The genesis and aims of certain market investigation studies and references.
 - The talent available at case team level at the OFT, and at the sectoral regulators.
 - The policy on concurrent competition powers for the sectoral regulators, and their use of these powers.
 - The overlap between the application of monopoly regulation and competition regulation.
 - The interaction between competition enforcement and the consumer bodies.
 - The assessment of the costs of regulatory actions.

A. The OFT and CC

Merger control

5. We endorse the system of independent review by the CC of the OFT’s first stage merger decisions. However, in recent years, and particularly since the EA02 restated the criteria for mergers to be referred to the CC on the

¹ We do not address here the role of the Financial Services Authority or the Pensions Regulator. The wider prudential and supervisory roles of those bodies constrain the making of useful comparisons with the economic regulatory functions of the other sectoral regulators.

basis that there is “*or may be*” [emphasis added] a substantial lessening of competition, there has been a step change in the level and type of scrutiny conducted by the OFT, due to its nervousness about the prospect of challenge. It is an example of the law of unintended consequences: the EA02 was meant to codify existing practice, and not to change it. It has been prompted in large part by the judgment of the CAT in *IBA Health*², which has made the OFT very – we would say excessively – cautious in making both reference and clearance decisions.

6. This in turn has led to unduly exhaustive and onerous first stage scrutiny by OFT of all cases, including the more straightforward ones; and, in our view, too many unnecessary references. The impact of these factors on the workload of the OFT has been exacerbated by the OFT’s propensity to bring cases within the ambit of the merger control by use of the “share of supply” test in EA02 – a test which often bears little or no resemblance to the definition of the affected markets on which the competition assessment proper depends. The OFT then experiences the difficulties described above in reaching a decision (either way) in these often straightforward cases.
7. In addition, there has been:
 - increased duplication by the CC of the analyses already conducted by the OFT at stage one; and
 - increased weight, and hence possibly undue influence, accorded to third party complainants (as prospective challengers of its decisions) by the OFT.
8. In these circumstances the former informal discussions, held with OFT staff as part of the assessment of how a proposed merger should be handled, are no longer of practical use. Indeed, the formal system of confidential guidance was also recently abandoned for a time (it is now reinstated on a more limited basis).
9. We think that there is now too much emphasis on judicial scrutiny and that a means needs to be found (including if necessary a modification of the reference test) both to give the OFT back some of its former discretion and to enable it to adopt a “fast-track” process for simple cases. This would enable it to:
 - reduce burdens on business as well as allowing OFT resources to be concentrated on more difficult cases;
 - restrict its information requirements to those issues which have a material bearing on the case; and
 - limit the scope for third parties to use poorly founded objections as a source of commercial leverage.

Competition Act cases

10. Recent decisions of the CAT have raised the question whether the OFT and the sectoral regulators retain sufficient discretion to close cases on administrative grounds in order to be able to prioritise cases for investigation.³ First, it is unclear in what circumstances a decision not to pursue a case might in fact be regarded as a substantive decision on the merits.⁴ This creates uncertainty as to whether the appeal lies to the

² CAT, Case 1023/4/1/03, 3 December 2003. The CAT’s decision was upheld by the Court of Appeal (Court of Appeal, Case C1/2003/2771, C1/2004/0036, C1/2003/2755), 19 February 2004.

³ See for example CAT, *Castling Book Limited/OFT*, Case 1068/2/1/06, 14 December 2006.

⁴ See CAT, *Aquavitae (UK) Ltd/Director General of Water Services*, Case 1012/2/3/03, 16 October 2003.

CAT, or to the administrative court for judicial review. In addition, case closure decisions are now regularly appealed, partly as a result of CAT rulings, and this is resource-intensive for the OFT and the sectoral regulators. There is a need for clarity on the extent of administrative discretion for the regulator to organise and prioritise its workload and where challenges to administrative discretion would be heard.

11. This issue raises, in turn, the question of how best to achieve the right balance between the CAT's objective of protecting the interests of complainants who are individuals or small businesses, whilst providing for more efficient despatch of the less well-founded and fruitless cases. A middle way is needed between expensive private enforcement actions, and the inefficient use of public resources that would result from even more case closure decisions being appealed to the CAT. Options include introducing an additional "screening" stage, or changing the test for appeal: either way, legislative change would be required.

Market investigations

12. The new regime of market investigations was designed to enable the OFT/CC to tackle issues which did not fall naturally within either the competition or consumer enforcement régimes. However, the test for a market investigation reference is a pure competition one: a prevention, restriction or distortion of competition. The OFT sometimes strains to find competition problems in such markets.
13. In practice, the way in which the OFT exercises its discretion in selecting markets for study and/or reference to the CC is opaque. Sources include: reviews of undertakings given in the context of previous monopoly or merger investigations,⁵ complaints by consumer bodies,⁶ and simply those sectors which have been the subject of repeated previous OFT attention.⁷
14. Our experience of dealing with the OFT and CC on these studies and references leads us to suggest that the Committee might pursue the following lines of enquiry:
 - whether the OFT assesses how much the cost to business and potential benefit to consumers (as distinct from the value of the market) of the study or reference is likely to be and what cost/benefit analyses it applies to its decisions;
 - what other criteria it applies to the selection of markets;
 - whether the OFT is satisfied that the possible decision to refer is clearly enough communicated to the industry participants in question – our experience suggests that a decision or impending decision to refer is often a surprise to those who are subject to it;
 - whether, as we think, this is an area where due process, and the right to be heard for those liable to be affected by any recommendations, is accorded much less priority than in either the merger context or the cartel/abuse of dominance context.

⁵ See for example the OFT's study of market for classified directory advertising services which was announced on 3 November 2004. On 5 April 2005 the OFT referred the classified directories market to the CC for investigation.

⁶ See for example OFT, The private dentistry market in the UK, March 2003.

⁷ See for example OFT, Estate agency markets in England and Wales, March 2004.

Quality and professionalism of staff

15. The increasing complexity and sophistication of competition law makes ever more stringent demands on the competition regulators, especially the OFT and CC. It is clear, however, to us as practitioners that the breadth and depth of experience and knowledge is not uniform across the OFT. This does not relate primarily to whether the staff in question are qualified in law or economics (although this matters); but rather simply to whether enough true talent is attracted, particularly at the case team level. At senior levels recruitment and retention seems less of a problem (though note the tendency for management layers to increase as staff are either moved up into new posts and their old posts filled from below, or new posts created for them to move up to⁸). But this does nothing to improve the situation lower down the hierarchy.
16. Among the sectoral regulators with concurrent powers the lack of breadth and depth of competition firepower is even more marked: this is hardly surprising since they are (a) fishing in the same pool as the OFT/CC and each other; and (b) trying to create a capability with a very small nucleus of competition expertise. This may go some way to explaining the very patchy record on competition work which is discussed below.

B. The Sectoral Regulators

Concurrent competition powers

17. Government has not applied a consistent policy in conferring competition powers on the sectoral regulators. We show these at [Appendix 1](#). There are some unexplained anomalies. Why, for instance, does the CAA have concurrent powers in relation to air traffic services (where any future competition is likely to focus on ownership changes), but not in relation to the airports sector (where to a large extent the same consideration applies)? In addition, the Airports Act 1986 is anachronistic in providing no licensing vehicle by which the CAA could introduce financial ring-fencing and provisions for the protection of assets and cashflows of the regulated business into the regulation of airports – for example, on change of ownership, a matter of current importance. Postcomm also lacks competition powers (but see below as to its future role). There are also some differences in regulatory architecture – for example the ability of Ofwat alone to accept undertakings in lieu of an enforcement order.⁹
18. Regulators have on occasion used (or sought to use) licensing arrangements in order to mimic competition law. The first instance was Ofcom's Fair Trading Condition in BT's licence. Ofgem's attempt to introduce a Market Abuse Licence Condition into generation licences was vetoed by the CC.¹⁰ Royal Mail's licence contains a provision prohibiting excessive or predatory pricing, despite the presence of price control across large parts of Royal Mail's portfolio and the application of competition law to Royal Mail generally. Overlaps of this kind could be reduced.

⁸ From October 2006 the OFT is working under a new structure with an "empowered senior management team". The new organisation chart is available on the OFT's website.

⁹ Under Section 19 (1b) of the Water Industry Act 1991, an enforcement order shall not be required if "the company has given, and is complying with, an undertaking to take all such steps as it appears to him for the time being to be appropriate for the company to take for the purpose of securing or facilitating compliance with the condition or requirement in question." The requirement to comply with the undertaking is in itself enforceable.

¹⁰ AES and British Energy – A report on references made under Section 12 of the Electricity Act 1989, Competition Commission, 31 January 2001.

19. Although the sectoral regulators are in some cases required, and in others have expressed a policy preference, to proceed under competition law wherever appropriate, as set out in [Appendix 1](#), in practice they have a good deal of discretion and there is no substantive check on the way they exercise it. Regulators are able to avoid difficult legal and economic issues relating to the application of competition law and instead attempt to deal with them using their discretionary powers under the licensing régime, a temptation which we feel they sometimes fail to resist.¹¹ Although it is probably futile to aspire to a rule that will cover every possible case, greater clarity could be achieved – for example a presumption in favour of competition law unless it is demonstrated to be inappropriate; and/or a presumption that, where a complainant alleges breach of competition law, that is what is applied, with departures having to be legally justified.

Have concurrent powers been consistently/successfully applied?

20. The acquisition of concurrent competition powers was a cause célèbre for the sectoral regulators, who believed it essential to complete the transition from regulated monopoly to fully liberalised markets. Provision was made in Section 60 of the CA98 and in the Concurrence Regulations requiring them to exercise their competition powers in a manner consistent with the approach of the EU and national competition authorities. However, in practice the effectiveness and professionalism with which these powers have been exercised has been at best patchy. Overall, Ofcom has performed reasonably well, both in the context of the services markets in which effective competition is most widespread and deeply entrenched¹² and in relation to the control of monopoly networks¹³. Ofwat, on the other hand, has been criticised roundly by the CAT at both the procedural and analytical levels¹⁴; and Ofgem followed one hugely information-intensive 34 month Chapter II investigation, which ended in a non-infringement finding, by industry-wide licence modifications on the same issue.¹⁵ In practice, CA98 investigations by the sectoral regulators have hardly ever led to infringement findings.¹⁶

Future of sectoral regulation

21. The Committee might consider whether the time has come to make a clearer distinction in both law and practice between those situations where regulation applies and those where competition law applies. The power of the sectoral regulators to impose fines for licence infringements (as in relation to competition infringements) has undermined any case for both regimes to be applied across the totality of any given sector.
22. We suggest that where the sectoral regulators are responsible for fixed network monopolies (e.g. electricity and gas transmission and distribution, water distribution and most water supply) the ability to apply *ex ante* licence

¹¹ See also Concurrent Competition Powers in Sectoral Regulation, DTI, May 2006,p.7.

¹² See for example the non-infringement decision regarding BT 0845&0870 retail price change – suspected Internet Service Provider (ISP) margin squeeze, 19 August 2004.

¹³ See for example the undertakings given by BT to Ofcom pursuant to the Enterprise Act 2002 in September 2005 in lieu of a CC reference.

¹⁴ *Albion Water and others v Water Services Regulation Authority*, Case 1046/2/4/04, 6 October 2006.

¹⁵ The provision of non-contestable connection services by DNOs: Amending Licence Condition 4C of the Electricity Distribution Licence – Consultation Document 68/05, Ofgem, March 2005.

¹⁶ There appears to be only one such case: the ORR's fining EWS for breach of the Chapter II CA98 prohibition (17 November 2006). But even then, this was the culmination of an enquiry started following complaints from Enron Coal Services Limited as early as 2001 and Freightliner Heavy Haul in 2002. In May 2004, ORR then issued a Rule 14 Notice to EWS that it was minded to make an infringement decision. Overall, the process lasted more than five years.

controls and industry-wide rules, and to flex them reasonably readily to deal with developing industry structure and practice, is a positive advantage. Here the distinction between regulating the provision of a network and the services which are offered over it is relatively readily drawn and the role of competition law less obvious.

23. Where there is full – or approaching full – competition in services such as energy supply, logic would suggest that concurrent powers create more demands in terms of maintaining a consistent approach than the results warrant. Here regulation could be withdrawn and competition law – as exercised by the OFT - relied upon.
24. More subtle differentiation is needed where – for example in communications – network competition is more feasible and the line between network services and “pure” service provision is more blurred. This helps to explain the stronger role for competition law in the regulation of both infrastructure and services in that sector. The Ofcom model also provides the more natural (in the circumstances of the sector) route of appeal to the CAT in place of licence modification reference to the CC or judicial review in the courts.
25. A similar analogy might be drawn in the case of postal services: in circumstances where Royal Mail’s network consists of both physical and human resources, and where barriers to entry in the provision of the delivery infrastructure are relatively low,¹⁷ monopoly regulation offers relatively little obvious advantage over competition law beyond the short term. Indeed, Postcomm is a rather outdated example of the “one regulatory body versus one dominant incumbent” model which has disappeared from both energy and communications.
26. Finally, although we appreciate that the role of consumer representation is being changed somewhat by the Consumers, Estate Agents and Redress Bill, we think that the Committee’s work on the sectoral regulators would not be complete if it did not look at their interface with the representatives of consumer interests. There has been very considerable difference of approach, with some of the latter focusing on resolving consumer complaints and others seeing themselves as watchdogs of the regulator – witness the current Postwatch judicial review proceedings against Postcomm¹⁸.

Costs and benefits of regulatory actions

27. We endorse the principle that the regulators should consult on their proposals in order to gain public legitimacy for their actions. However, some consultations (i) are at such a level of detail as to be overkill; (ii) are impenetrable by anyone other than industry participants and the closest industry watchers; or (iii) are consultation for consultation’s sake¹⁹. We consider that public consultations should address those issues in which, and at a level at which, the public are likely to have a genuine interest.
28. We also consider that proposals to introduce new regulations or apply existing ones should mean regulators carrying out a proper cost benefit analysis. This requirement of the Better Regulation Initiative is often paid lip service but rarely applied rigorously.
29. We do not underestimate the difficulties of conducting these analyses. But it should be borne in mind that the regime is already onerous for regulated entities. They employ full-time compliance teams. A market investigation, particularly one run by the Competition Commission, may be expected to cost the enterprises

¹⁷ See ECJ, *Oscar Bronner v Mediaprint*, Case C-7/97, 26 November 1998,

¹⁸ See High Court, Case C-7/97, Case CO/1859/2005, 19 December 2005.

¹⁹ See for example Ofel’s consultation on its use of public consultation, February to August 2001; Postcomm review on its consultation procedure, October 2000; ORR consultation on its approach to focused and effective regulation (November 2006, not yet completed).

involved several millions of pounds. We estimate the legal cost alone of a complex merger clearance from the OFT at £0.5 million, while that of a case that is referred to the CC will be a further £1 million.

30. The indirect costs must also be considered. For example:
- utilities' price control cycles may disincentivise long-term investment, since they can predict their income streams with a degree of certainty over a typical period of only five years;
 - for an enterprise subject to a market investigation, it may be impossible to make strategic decisions for years due to uncertainties over the future regulatory environment; and
 - a regulated enterprise planning a new innovative product (perhaps as a competitive response to competition from new entrants) has to factor into its analysis the cost of obtaining regulatory approval and the cost of losing first mover advantage in the process.
31. Our observations suggest that there is a tendency to overlook the burdens placed on business by regulatory activity. Regulatory Impact Assessments are based on a worthy aim but in practice tend to be so superficial as to be worthless.
- A regulator considering new regulation should presume that the cost will outweigh the benefit unless a strong case can be made that it will not.
 - An emphasis on fewer, more targeted consultations, and on allowing the industry to settle issues itself where possible, would increase legitimacy and reduce cost.
32. Finally, we support external review of regulators' affairs. However, we doubt that the National Audit Office is able to cover the waterfront with sufficient depth and timeliness. The Committee might consider whether some more immediate scrutiny of selected decisions would provide a stronger spur to efficiency and effectiveness on the part of the regulators.

8 February 2007

Summary of Sectoral Regulators
Competition and Licence Enforcement Powers

Sectoral Regulator	Concurrent Powers	Enforcement of Licence Conditions	Enforcement of Competition Law and Cooperation with OFT
Ofgem	Yes 6 cases investigated under the CA 98 between 2001 and 2005 ²⁰	<ul style="list-style-type: none"> ➤ Provisional and final enforcement orders ➤ Financial penalty of up to 10 % of turnover 	Where an agreement or conduct has an impact on the markets regulated by Ofgem, the case will be allocated by agreement with the relevant competition authorities to the authority "best placed" to act (see OFT 428, January 2005). Section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989 set out the factors Ofgem should consider when deciding to use its powers under these Acts to address anti-competitive behaviour. In particular, Ofgem may not take enforcement action under the sector-specific Acts if it is satisfied that it would be more appropriate to address the issue under the CA 98. In applying the CA 98 (see s. 28 of the Gas Act 1986 and s. 25 of the Electricity Act 1989), Ofgem may take account of its duties under the Gas and Electricity Acts only to the extent that they are relevant factors under UK and EC competition law.
Ofwat	Yes (England and Wales only) 4 cases investigated under the CA 1998 between 2001 and 2005 ²¹	<ul style="list-style-type: none"> ➤ Provisional and final enforcement orders ➤ Financial penalty of up to 10 % of turnover 	OFT 422, February 2000: "Where a particular agreement falls within the scope of the Water Industry Act 1991 as well as one of the prohibitions in the [Competition] Act, [Ofwat] is able to decide to use [its] powers under either the Water Industry Act 1991 or the [Competition] Act. In such cases [Ofwat] will make use of whichever statutory powers [it] judges to be the more appropriate to address the specific conduct. Where [it] takes action using [its] powers under the [Competition] Act, [its] duty to take enforcement action under the Water Industry Act 1991 does not apply..."
Ofcom	Yes 23 cases investigated under the CA 98 between 2001 and 2005 ²²	<ul style="list-style-type: none"> ➤ Detailed enforcement order and financial penalties regime ➤ Many of Ofcom's decisions using sectoral powers are subject to appeal to CAT under the CA 98 	<ul style="list-style-type: none"> ➤ Duty in relation to broadcasting powers (s. 317 Communications Act) to consider whether a case can be dealt with using powers under the Competition Act before considering whether to use sectoral powers. ➤ "Committed to using the Competition Act where appropriate" (Ofcom guidelines for the handling of competition complaints and disputes).

²⁰ See page 19 DTI Report on Concurrent Competition Powers in Sectoral Regulation May 2006.

²¹ *Ibid.*

²² *Ibid.*

Sectoral Regulator	Concurrent Powers	Enforcement of Licence Conditions	Enforcement of Competition Law and Cooperation with OFT
ORR	Yes (in respect of agreements or conduct relating to the supply of services relating to railways) 6 cases investigated under the CA 1998 between 2001 and January 2007 ²³ ; one infringement decision ²⁴	<ul style="list-style-type: none"> ➤ Provisional and final enforcement orders ➤ Financial penalties of up to 10 % of turnover 	<ul style="list-style-type: none"> ➤ OFT 430, October 2005: "In circumstances where ORR could proceed by way of its powers under the Competition Act or its sectoral powers, ORR will decide at an early stage under which power it is more appropriate to investigate... The overriding principle is that ORR will seek to use the most effective, efficient and expeditious solution... As a general guide, if there are no specific sectoral powers available to ORR (such as access provisions in the Railways Act which allow ORR to direct the relationship between a supplier of infrastructure and the train operator) and ORR has grounds for suspecting that ...the Competition Act [has] been infringed, it will exercise its powers under that Act. If ORR is satisfied that the most appropriate way of proceeding is under the Competition Act, it is relieved of its duty to take enforcement action by way of a provisional or final order under the Railways Act." (see Section 55(5A) Railways Act 1993) ➤ From January 2006 ORR removed competition based licence conditions from operator licences that predated the Competition Act and the Enterprise Act on the basis that concurrent powers now serve these functions²⁵

²³ Ibid, page 19, only mentions 3 investigations between 2001 and 2005; ORR's homepage indicates that 6 investigations have taken place.

²⁴ *English Welsh and Scottish Railway Limited*, 17 November 2006.

²⁵ Op. cit. 4, page 27.

Sectoral Regulator	Concurrent Powers	Enforcement of Licence Conditions	Enforcement of Competition Law and Cooperation with OFT
CAA	<p>Yes for supply of air traffic services (i.e. air traffic control and related services)</p> <p>No for other areas of aviation activities</p> <p>CAA has not yet exercised its concurrency powers.²⁶</p>	<ul style="list-style-type: none"> ➤ Currently, NERL is the only supplier of air traffic services under an exclusive licence until 2011. ➤ The Government has exempted other providers of air traffic services from licensing requirements, in particular those, such as NSL, which provides services at aerodromes²⁷. The exemption expires in April 2011, i.e. CAA's licensing powers do not apply to these providers. 	<ul style="list-style-type: none"> ➤ S. 21 of the Transport Act prohibits CAA from using its powers to enforce the Licence if it is satisfied that the most appropriate way of proceeding is under the Competition Act. ➤ However, NAA's competition powers are doubtful: In March 2004, CAA received legal advice that NERL was not an undertaking for the purposes of competition law. CAA concluded that the reasons why NERL should not be considered an undertaking could also apply to NSL. ➤ NERL's licence contains three competition-related conditions (2.7, 2.8 and 9). ➤ With respect to NERL, CAA will decide on a case-by-case basis whether it is more appropriate to use its licensing powers or its (less certain) competition powers. The question of whether or not NERL is an undertaking would then have to be referred to the courts²⁸ ➤ No licensing powers with respect to NSL, i.e. CAA has to consider complaints under competition powers (the extent of such powers to be decided by the courts.)
Postcomm	No	<ul style="list-style-type: none"> ➤ Provisional and final enforcement orders ➤ Financial penalty of up to 10 % of turnover ➤ Powers to issue enforcement order and impose financial penalties are not interdependent (see Section 30 (3) PSA). 	<ul style="list-style-type: none"> ➤ Postcomm uses its licensing powers to cover competition law issues (e.g. Condition 11 contains provisions on the promotion of effective competition) ➤ Postcomm has exercised its regulatory powers to require Royal Mail to act in a manner consistent with competition law through the imposition of licence conditions to that effect (e.g. Condition 11). Postcomm feels that even if it did have concurrent powers there would be relatively few differences in how to pursue individual cases (see MoU between Postcomm and OFT dated June 2003)

²⁶ *Ibid.*

²⁷ The Air Traffic (Exemption) Order 2001 SI 2001 No. 287.

²⁸ See *Air Traffic Services and Competition Law – A CAA Policy Document, April 2006*, page 13.