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When markets are failing (Part 2)

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When markets are failing

The concluding instalment in our two-part article looking at the use of market investigations and sector inquiries in competition law

by *Philip Marsden and Peter Whelan**

In this second part of the article (for part 1, see *CLI* 16 January 2007 p6) we examine (1) the similarities and differences between the EC and UK approaches to market investigations/sector inquiries; and (2) best practices that aim to maximise the benefits and minimise the costs of market/sector investigatory tools.

Comparing EC and UK approaches

There are some obvious similarities between the market investigation regime of the UK and its European counterpart, the sector inquiry:

- Both regimes attempt to deal with market failure.
- The power to initiate a market investigation or a sector inquiry is discretionary.
- There is a clear legislative basis for the powers necessary to carry out market investigations/sector inquiries effectively.
- The relevant enforcement bodies are endowed with coercive powers to enable them to acquire the specific information they require in order to fulfil their duties.
- Market investigations and sector inquiries are elements of a proactive approach to competition policy (although they are also both reactive in the sense that they may be initiated as a result of complaints received by the authorities).
- They are both potentially very useful in terms of their output – that is to say, the information that is obtained through such investigations may be helpful not only for the competition authorities themselves in the exercise of their respective powers but also for other administrative and public bodies. If, for example, the market failure in question arises from laws, regulations or government policies, the investigating competition authority could use its report to present recommendations for changes to these laws or regulations or to advise on appropriate policy changes.

What is perhaps more interesting, though, is the number of significant differences between the EC and the UK regimes.

■ **The number of authorities.** First, the UK procedure involves a two-step approach with two different authorities. The OFT decides whether a market investigation is warranted. If the legal test contained in the Enterprise Act 2002 is fulfilled, this authority may decide to refer the market to the Competition Commission for examination. At EC level, by contrast, the European Commission is the body that is charged with deciding both whether to investigate a market and whether, following the investigation, the market is indeed distorted or restricted.

■ **Degree of discretion.** Second, at a superficial level at least, the Commission seems to have more discretion than the OFT in relation to the initiation of an investigation. For the Commission, all that is required is a *suggestion* that competition is restricted or distorted; the OFT on the other hand must have a *reasonable suspicion* that markets are failing. It should be remembered, however, that the OFT interprets the different elements of the reference test quite broadly (see for example para 4.2 of the OFT 511 (March 2006) guidance).

■ **Different philosophies.** Third, EC sector inquiries are based on a different philosophy, and thus are narrower in their scope, than UK market investigations. Sector inquiries are used by the Commission to investigate a market with a view to pursuing violations of article 81 or 82 afterwards; the same cannot be said for the UK where market investigations may result in a number of different remedies being adopted by the Competition Commission. An EC sector inquiry thus probably requires more justification than its UK equivalent: a potential follow-up with article 81/82 cases will have to be a likely outcome of such an inquiry.

■ **Remedies available.** Fourth, and following on from the previous point, the Competition Commission, in contrast to its counterpart in Brussels, has the power to adopt a wide range of measures designed to remedy an identified defect in the market. According to Competition Commission guidelines, such remedies could include measures:

- designed to make a significant and direct change to the structure of a market (for example, through divestment);
- designed to change the structure of a market less directly (for instance, by reducing entry barriers or switching costs, by requiring the licensing of knowhow or intellectual property rights, or by extending the compatibility of products through industry-wide technical standards);
- directing firms to discontinue certain conduct (for example, giving advance notice of price changes) or to adopt certain behaviour (for instance, displaying prices and other terms and conditions of sale more prominently);
- designed to restrain the way in which firms would otherwise behave (for example, the imposition of a price cap); and
- relating to monitoring – for instance, a requirement to provide the OFT with information on prices or profits (see further para 4.18 of the Competition Commission CC3 (June 2006) guidelines).

This is an impressive array of potential remedies. However, certain measures – for instance, changes to regulations and

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measures to improve market transparency – would have to be imposed by other bodies. The European Commission, in contrast, can only pursue formal competition law cases using its powers to enforce articles 81 and 82.

■ **Breadth of inquiry.** Fifth, as no specific market (in competition law terms) is identified in the EC context, the potential breadth of a sector inquiry is usually much wider than its UK counterpart, the market investigation. It is here, if anywhere, that DG Comp may leave itself open to allegations of trying to conduct “fishing trips”.

■ **Public consultation.** Sixth, there is a noticeable difference in methodology between the two approaches in relation to the use of public consultation. While the OFT, the Competition Commission and the European Commission are not obliged to consult interested parties before opening a market study, market investigation or sector inquiry, the UK authorities are (according to section 169 of the Enterprise Act) under a general obligation to consult if the relevant decision is “likely to have a substantial impact on the interests of any person” – and typically do in most cases. “Relevant decisions” include decisions relating to whether or not to refer (and indeed those relating to whether or not there has been a restriction or distortion of competition).

■ **Transparency.** Seventh, the level of transparency is not the same with both procedures. There is a significant degree of transparency within the UK; there is practically none in the EC. This difference in approach can be explained to some extent by the different nature of the investigatory tools in question; the lack of transparency at EC level may be attributable to the fact that an inquiry has as its purpose the initiation of future infringement proceedings in the EC.

■ **Hearings.** Eighth, although both jurisdictions rely heavily on documentary evidence, oral hearings have taken place; they occur far more often under the UK regime than with EC sector inquiries. In the EC, the views that are expressed as a result of an inquiry are based substantially on the information received through the use of questionnaires; hearings are rare. A UK market investigation will usually involve at least three hearings – the issues hearing, the emerging-thinking hearing and the hearing on proposed remedies (see further Doran and Quinn).

■ **Politicisation.** Finally, it is arguable that the EC approach is more politicised than that of the UK, in that it tends to investigate those sectors that are attracting the most media attention. The current inquiry into the financial services sector would possibly be an example to support this claim. Indeed, in its preliminary report, the Commission was highly critical of the industry as a whole, complaining of the size of the profits earned, for example. That this inquiry had come about despite the fact that numerous cases relating to banking and the payment card industry had already been taken up at EC level is perhaps further evidence of the hardline approach that the European Commission has brought to bear on this sector.

By contrast, the UK regime tends to act as a safety valve against unnecessary government intervention in markets as it can be used to take the steam out of any movement to introduce government regulation in a particular market. This is true as the UK system allows the investigating competition

authority to remedy identified market failures. Thus the Competition Commission is not only able to examine a market and argue why particular government intervention is not warranted, it can also demonstrate through reasoned action how the market failure should be dealt with effectively. In other words, the UK approach has the inherent ability to head off complaint-driven intervention that may result in more severe action than is necessary. This in turn leads to a more principled intervention and undermines efforts to support more politically motivated measures.

Some, however, might argue that the above interpretation of the workings of the UK system is too kind and that the OFT bows to political pressure as much as the Commission. They might also argue, for example, that the tight timeline for response by the OFT to a super-complaint – coupled with the threat of judicial review – ensures that a Competition Commission reference is almost inevitable following such a complaint.

It is submitted here that, even if correct, this inevitability does not negate the essential point made in the above argument concerning the ability of the Competition Commission to prevent unwarranted government intervention or regulation. As explained, once underway a market investigation procedure – through the use of effective remedies on the Competition Commission’s part – may often reveal to the government and to other interested parties how market failure can be rectified in an effective manner (and one which takes due account of the possible future burdens faced by undertakings active in the market). This reduces the likelihood that unnecessary political intervention or government regulation will follow.

Recommendations for the future

This section attempts to identify a number of “best practices” aimed at improving current EC and/or UK investigation processes. These best practices include, in no particular order of preference, the following:

(1) **Discipline.** A certain level of discipline at the competition authority level is required in order for the market investigation/sector inquiry regimes to function correctly. Great care should be taken to ensure that they do not become overused or that they are not used to replace the more traditional forms of competition law enforcement enshrined in articles 81 and 82 EC or the Chapter I and II prohibitions. These tools must be perceived to be of the “once in a lifetime” variety. It is true that they can bring great publicity to an issue/industry, but there is always the risk of bringing very little added value if overused, especially if one could have used another policy tool that is better, quicker or less resource-intensive. In short, only the right cases should be taken under these regimes; authorities must be patient in their search for such cases.

(2) **Appropriateness.** It must always be remembered that although market investigations and sector inquiries are indeed a useful tool for dealing with market failure, they are nonetheless a very specific tool (see for instance para 2.1 of the OFT 511 (March 2006) guidance). It is important to be aware that these types of procedures are not tailored for all purposes. In particular, they are not appropriate:

Failing markets (Part 2)

- for dealing with allegations of collusion in the market concerned;
- if investigatory tools are not required to obtain the information that is sought;
- if the suspected problem only involves a very limited number of players in the market; or
- if the net result is not worth the amount of resources required to achieve it.

(3) Ex ante cost-benefit analysis. To the extent possible, a thorough ex ante cost-benefit analysis of the proposed investigatory tool and approach should always be carried out by the relevant authorities. Such an analysis would allow the authorities to determine if the result contemplated is worth the amount of resources required to achieve it (as per the last bullet point in *Appropriateness* above) and thus would significantly aid them in their attempts to allocate their scarce resources in the most efficient manner possible.

(4) Consultation. In addition to fulfilling their current legal obligations regarding consultation, the agencies should be encouraged to consult with interested parties both before an investigation is undertaken and during the process itself. Increased consultation can help to improve the adequacy of the design of the investigation (for instance, the questionnaires) and reduce the resultant burdens on undertakings; allow organisations such as Which? to present the views and concerns of final consumers in the market; and reduce the scope for unpleasant surprises later in the process. One-to-one meetings between an undertaking (or a consumer group) and the authority are to be preferred to public meetings whenever practical, as they are generally more effective in getting to the real issues relating to the market failure, especially those affecting consumers in general.

(5) Transparency. For reasons of democracy and fairness, it is important that a transparent investigatory regime is created and maintained. The internet provides an ideal cheap and effective method of communicating emerging thinking and embryonic ideas to interested parties and the general public; it should be used as much as is practicable by the authorities. At present, the UK agencies appear to be more aware of the usefulness of this resource than their European counterpart.

(6) Design. More effort and greater care should be expended at the design stage of the process as badly drafted questionnaires waste time and limited resources, breed frustration among the undertakings concerned, and undermine the legitimacy of the investigatory procedure. There are three suggestions in this regard:

- Questionnaires should not only be drafted with the business community in mind but also in such a manner as to enable other important entities (for example, consumer organisations) to present their views in a logical and comprehensive manner.
- The agencies should use the pre-investigation consultation process to give interested parties an input into what is investigated.
- The authorities should only request information that it can analyse effectively, given its limited resources.

(7) Acceptance of undertakings. The acceptance of undertakings in lieu of an investigation should be the exception rather than the rule. Undertakings should only be

accepted in those (relatively infrequent) cases where an adverse effect on the market has already been identified and where the remedial action proposed would effectively put an end to the market failure in question. It should be noted that, in the EC, undertakings can only be accepted once an article 81/82 investigation has begun.

(8) Time bar rules. It is not advisable to introduce a prohibition on investigating the same markets again within a specified time limit, whether through legislation or agency practice. There are two main reasons for this:

- it is not desirable that market players become aware of such a policy as they may interpret it as giving them free rein – within the confines of the competition laws, of course – to act in a manner which is not beneficial to the market over such a period; and
- more importantly, the remedies imposed may require monitoring in order to see if they have achieved/are achieving their aims.

(9) Evidence of burdens faced. It is often claimed that market investigations / sector inquiries place large burdens on the undertakings in the market being examined. However, there seems to be a lack of any detailed empirical evidence about such burdens and the inevitable opportunity costs they involve. Studies should be undertaken in each of the jurisdictions to record and measure the real extent, in financial terms, of the obligations imposed on the undertakings that have already been subjected to review. These studies could then be used to inform the ex ante cost-benefit analysis advocated above.

(10) Ex post cost-benefit analysis. Resources should be made available to conduct ex post evaluations of the usefulness or otherwise of the market investigations / sector inquiries, as has occurred at EC level in the area of merger control. This ex post analysis may involve two particular elements:

- evaluation of the “appropriateness” of the investigation; and
- evaluation of its “effectiveness”, although often both of these concepts will be inextricably linked.

In any case, “effectiveness” in the UK context will undoubtedly involve examination of any particular remedies imposed; for the EC, it may reflect itself in the number of successful competition law cases completed as a result. With both regimes, it would be advisable if a certain amount of time (say, two to three years) was allowed to pass before either attempting to determine either “appropriateness” or “effectiveness”.

If the above 10 suggestions are taken on board by the authorities, it is argued that both the UK and EC regimes can make an ever greater contribution than they do at present to helping to identify and improve market failure in any one of a number of different markets and sectors.

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