

# **‘Baseline’ annual report on concurrency – 2014**

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## Foreword

*by Alex Chisholm, Chief Executive, the Competition and Markets Authority*

The legislation that established the Competition and Markets Authority or CMA – the Enterprise and Regulatory Reform Act 2013 – requires us to produce, every year from the end of our first year of operation (ie from after March 2015), a ‘report containing an assessment of how the concurrency arrangements have operated during the year’. The concurrency arrangements are the arrangements for co-operation between the CMA and sectoral regulators regarding the competition law functions that each regulator is empowered to exercise concurrently with the CMA in its sector, and the new legislation introduces provisions for enhancing those concurrency arrangements.<sup>1</sup>

Although that legal obligation to produce an annual concurrency report binds us only from next year, we thought it would be appropriate and helpful to issue an initial ‘baseline’ report this year – as we begin our role and the new concurrency arrangements come into force. We see this voluntary baseline report as the starting point for debate and engagement with the industries concerned – including, in each sector, providers (the regulated companies), consumers (business and domestic users) and regulators. It is a *baseline* report; it is not, and cannot yet be, the ‘assessment’ of concurrency arrangements that the statute requires us to produce in future years.

Looking to the future, we set out at the end of each sector chapter in this baseline report a summary of points from the annual plans or other published documents of each regulator of what are expected to be the major issues, in terms of competition law enforcement and competitive outcomes more generally, in the year ahead.

Also with a view to the future, we are inviting interested parties to comment on what they would like to see in future annual concurrency reports, and on issues they would like raised in strategic dialogue between the CMA and sectoral regulators.<sup>2</sup> We have not yet had the benefit of such comments from people outside the regulator community in the framing of this baseline report.

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<sup>1</sup> Enterprise and Regulatory Reform Act 2013, Schedule 4, paragraph 16. The sectoral regulators for this purpose are: the CAA (Civil Aviation Authority), in respect of air traffic services and airport operation services; Ofcom (Office of Communications), in respect of communications (telecommunications, broadcasting and postal services); Ofgem (Gas and Electricity Markets Authority), in respect of electricity and gas in Great Britain; the FCA (Financial Conduct Authority), in respect of financial services and the Payment Systems Regulator in respect of inter-bank payment transfer systems (from April 2015); Monitor, in respect of health care services in England; the ORR (Office of Rail Regulation), in respect of railway services; Ofwat (Water Services Regulation Authority) in respect of water and sewerage services in England and Wales; and the NIAUR (Northern Ireland Authority for Utility Regulation), in respect of electricity, gas, and water and sewerage services in Northern Ireland.

<sup>2</sup> See paragraphs 24 and 25 of this report.

The production of this baseline report has itself involved a considerable collaborative effort. The regulators have contributed valuable material about their sectors, and have had an opportunity to comment on drafts of the report as a whole. It is an encouraging start to the enhanced cooperation between us all under the new concurrency arrangements.

In the meantime, as the CMA now assumes its functions and duties, and as the new concurrency arrangements take effect, we hope that this baseline report will be of value to all with an interest in achieving more effective markets and competitive outcomes, for the benefit of consumers, in the regulated sectors.

**Alex Chisholm**

*Chief Executive*

*Competition and Markets Authority*

*April 2014*

## A. The purpose of this report

### Context:

#### Concurrency – The application of competition law in the regulated sectors

1. Under the Enterprise and Regulatory Reform Act 2013 (which in this report is referred to as ‘the ERRA13’), a number of changes have been made to competition laws, procedures and institutions in the United Kingdom.
2. Among these changes are:
  - The establishment of the Competition and Markets Authority, or CMA, which from April 2014 replaces the Office of Fair Trading (OFT) and the Competition Commission as the UK’s principal competition authority.
  - For the regulated sectors, reforms to strengthen the regime under which competition law is applied in the regulated sectors, not only by the CMA, but also by the sectoral regulators exercising competition law powers in the sectors for which they are responsible<sup>3</sup> – notably their powers (existing or soon-to-be-conferred):
    - to apply the UK and EU law prohibitions on undertakings<sup>4</sup> engaging in anticompetitive agreements or in the abuse of a dominant market position<sup>5</sup>
    - to conduct market studies, and if appropriate to make a market investigation reference under which the CMA (until March 2014, the Competition Commission) conducts an in-depth investigation into

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<sup>3</sup> Although there are various definitions for different purposes, in this document the term ‘sectoral regulators’ refers to the following entities which have, or are expected in due course to have, competition law powers:

- the CAA (Civil Aviation Authority), in respect of air traffic services and airport operation services
- Ofcom (Office of Communications), in respect of communications (telecommunications, broadcasting and postal services)
- Ofgem (Gas and Electricity Markets Authority), in respect of electricity and gas in Great Britain
- the FCA (Financial Conduct Authority), in respect of financial services – which is also establishing the Payment Systems Regulator in respect of inter-bank payment transfer systems with effect from April 2014; at present neither the FCA nor the Payment Systems Regulator yet has full concurrent competition powers, but the Financial Services (Banking Reform) Act 2013 provides that both the FCA and the new Payment Systems Regulator will have this full set of powers from April 2015. In the 2014 Budget, it was that the Payment Systems Regulator acquires the concurrent power to make market investigations references from April 2014
- Monitor, in respect of health care services in England
- the ORR (Office of Rail Regulation), in respect of railway services
- Ofwat (Water Services Regulation Authority) in respect of water and sewerage services in England and Wales
- the NIAUR (Northern Ireland Authority for Utility Regulation), in respect of electricity, gas, and water and sewerage services in Northern Ireland

<sup>4</sup> An ‘undertaking’ is a legal concept that is often defined as an autonomous economic entity, and broadly speaking corresponds to the concept of a business.

<sup>5</sup> The UK prohibitions are in Chapters I and II of the Competition Act 1998, and the equivalent EU prohibitions are in Articles 101 and 102 of the Treaty on the Functioning of the EU. The EU prohibitions apply only if the agreement or abuse in question may have an appreciable effect on trade between member states of the EU.

whether any feature, or combination of features, of a market in the UK for goods or services prevents, restricts, or distorts competition.<sup>6</sup>

These powers are exercisable concurrently by the sectoral regulators and by the CMA (until March 2014, by the OFT). The arrangements by which the CMA and the sectoral regulators apply competition law in the regulated sectors are often known as '**concurrency**' arrangements.

3. The CMA sees the strengthening of the concurrency arrangements as part of an overall approach which is intended to enhance competition and make markets work more effectively in the regulated sectors, achieving more competitive outcomes for the benefit of consumers. These competitive outcomes may be achieved by the greater application of competition law, and also by other means including liberalisation measures and the use of direct regulation to promote competition.
4. The CMA and the sectoral regulators consider that competitive markets are a key driver of productivity, innovation and economic growth, providing greater choice and other benefits for consumers.<sup>7</sup> These benefits include downward pressure on prices, upward pressure on quality, spurs to efficiency and innovation. The changes to the concurrency arrangements which are set out in the ERR13 are designed to ensure that the CMA and the sectoral regulators work more closely together and that they build up and continue to share competition expertise, including through enforcement work, training and research.

### **The legislative measures to strengthen the concurrency arrangements**

5. The provisions in the ERR13 for strengthening the concurrency arrangements take effect from 1 April 2014 and involve, principally, the following measures:
  - The sectoral regulators will now, before they can use their direct regulatory powers of enforcing licence conditions, have to consider whether it would be more appropriate to proceed by using their powers to apply the UK and EU prohibitions on anticompetitive agreements or abuse of a dominant position.<sup>8</sup>

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<sup>6</sup> The market investigation provisions are in Part 4 of the Enterprise Act 2002.

<sup>7</sup> UK Competition Network, Statement of Intent, 2 December 2013, Annexe 1.

<sup>8</sup> Some of the sectoral regulators have had even before now a similar obligation (notably Ofcom for broadcasting, the ORR and Ofgem), as more fully explained in paragraph 42. The new duty in the ERR13 does not currently apply to the health care regulator Monitor, but the Secretary of State may apply this duty to Monitor at a future date.

- The Secretary of State is empowered to make regulations requiring the CMA and sectoral regulators to share more information about possible cases under the UK prohibitions; indeed, such regulations have already been made, by way of The Competition Act 1998 (Concurrency) Regulations 2014.
- The CMA is empowered to decide which body should lead on a case, and in particular may decide to take a case on itself if it 'is satisfied that its doing so would further the promotion of competition, within any market or markets in the United Kingdom, for the benefit of consumers'.<sup>9</sup>
- The CMA is empowered to take over a case from a sectoral regulator, even if the sectoral regulator is already investigating that case, where, again, the CMA is satisfied that its doing so 'would further the promotion of competition, within any market or markets in the United Kingdom, for the benefit of consumers'.<sup>10</sup>

### **The requirement for an annual report**

6. The ERRA13 also provides that the CMA must prepare an annual report containing an assessment of how the concurrency arrangements have operated during the year. This report must include information about the activities of the CMA and the sectoral regulators in relation to the exercise of all concurrent functions.<sup>11</sup>
7. The ERRA13 provides that the CMA must publish the annual report as soon as practicable after the end of each financial year of the CMA. The first report required by statute must therefore be published as soon as possible after the end of March 2015.<sup>12</sup>

### **This 'baseline' annual report**

8. Nevertheless, and in advance of the first annual report due after March 2015, the CMA and the sectoral regulators – working together in the new UK Competition Network (UKCN)<sup>13</sup> – have decided that, in the interests of

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<sup>9</sup> The Competition Act 1998 (Concurrency) Regulations 2014, reg 5. This will not, however, apply to cases that are principally concerned with matters relating to the provision of health care services for the purposes of the NHS in England, in respect of which Monitor will lead on the case, unless otherwise agreed.

<sup>10</sup> The Competition Act 1998 (Concurrency) Regulations 2014, reg 8. This will not, however, apply to cases taken by Monitor that are principally concerned with matters relating to the provision of health care services for the purposes of the NHS in England.

<sup>11</sup> Paragraph 16(3) of Schedule 4 to the ERRA13 prescribes the information that must be included in the annual report.

<sup>12</sup> See paragraph 16 of Schedule 4 to the ERRA13.

<sup>13</sup> See press release: [www.gov.uk/government/news/network-launched-to-help-drive-competition-in-regulated-sectors](http://www.gov.uk/government/news/network-launched-to-help-drive-competition-in-regulated-sectors). The health care regulator Monitor, which has a statutory duty to prevent anticompetitive behaviour, is not a full member of the UKCN but will attend the UKCN with observer status.

accountability and transparency, it is appropriate to publish this ‘baseline’ report now, at the start of the CMA’s first year.

9. The report seeks to assess the current state of the UK ‘concurrency’ arrangements and to provide the evidence by which to determine what further action is required to make improvements to the regime.
10. In this ‘baseline’ report we first set out the CMA’s approach to the application of competition law in the regulated sectors. We then describe, for each of the regulated sectors, the role of competition law and direct regulation powers in promoting market mechanisms to further the interests of consumers in those sectors, having regard in particular to:
  - general market conditions in the sector concerned
  - how the relevant sectoral regulator’s competition law powers and duties fit with its other powers and duties
  - how the sectoral regulator’s direct regulatory powers have been used to promote competition
  - examples of competition law cases recently or concurrently pursued by the sectoral regulator
11. The CMA has worked with the sectoral regulators in preparing the baseline report, and the regulators have provided much of the material on their sectors.

#### **Future annual concurrency reports (from 2015 onwards)**

12. With a view to making the annual concurrency report which the CMA will be obliged, by statute, to publish after its first year of operations (ie from 2015 onwards) as effective and useful as possible, the CMA would welcome any comments or suggestions from interested parties.

#### ***Assessing the operation of the concurrency arrangements***

13. In Chapters C to J of this report we provide descriptions of the operation of the concurrency arrangements in each of the sectors in which a sectoral regulator has concurrent powers. In future CMA annual concurrency reports, our intention is that these chapters will provide an overall assessment of the operation of the concurrency arrangements during the previous year. For this baseline report, we have set out the way in which we currently envisage undertaking this assessment in future years. In particular, we set out the criteria by which we consider it may be appropriate to assess the operation of the concurrency arrangements, and some of the ways that we envisage these criteria being applied.

### *Criteria for assessment*

14. In our *Vision, Values and Strategy* document,<sup>14</sup> we set out five goals that we have set ourselves in the context of our duty to promote competition and our mission to make markets work well, in the interests of consumers, businesses, and the economy. Three of these goals are particularly relevant to the concurrency arrangements:

- (1) delivering effective enforcement
- (2) extending competition frontiers
- (3) developing integrated performance

15. We consider that these goals provide an appropriate basis for framing future assessments of the operation of the concurrency arrangements. That is, we consider it appropriate for those assessments to ask:

How, and to what extent, has the operation of the concurrency arrangements assisted with the achievement of our goals, and to the wider objectives of improving the working of markets, benefiting UK consumers and enhancing economic growth?

16. The following paragraphs highlight some of the factors we would expect to consider.

#### *(1) Delivering effective enforcement*

17. Targeted and effective enforcement delivers results beyond individual cases – it builds a platform for greater compliance and understanding of the law, and, importantly, deters anti-competitive behaviour.

18. We envisage future annual concurrency reports providing a summary of the use of concurrent competition prohibition powers (ie the prohibitions in the Competition Act 1998 and the equivalent EU prohibitions) across the regulated sectors in the relevant year, and to consider changes over time. This includes a cross-sectoral and temporal review, in respect of the prohibitions, of:

- the number of formal or substantial complaints
- the number of investigations formally launched
- the number of investigations that resulted in infringement decisions
- the number of investigations that resulted in the giving of commitments

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<sup>14</sup> CMA, *Vision, values and strategy for the CMA*, CMA 13, January 2014, pages 1 to 2.

- the number of investigations that resulted in an exemption or ‘no action’ or equivalent decision

Of course the size and market significance of individual cases can matter at least as much as the number of cases, and we envisage the report giving appropriate context to the numerical data.

19. The report is then likely to consider:
  - (a) **Case allocation and management:** Approaches taken to case allocation and management – identifying relevant developments, differences and lessons learned.
  - (b) **Case decisions:** Review of infringement and other decisions. Any lessons learned would be identified (for example, in relation to the use of commitments or other approaches that may have assisted in a timely and effective resolution).
  - (c) **Appeals:** Appeals can be a sign of the normal functioning and testing of boundaries/interpretations, but can also highlight particular areas where analysis and processes could be improved. Any lessons learned would be identified.
20. This part would also be likely to consider other actions that the CMA and/or sectoral regulators have taken to ensure that businesses and individuals understand the law.

## (2) *Extending competition frontiers*

21. The report will provide an overview of where consideration has been given to extending the frontiers of competition including through:
  - the initiation of a market study
  - other regulatory review activity; including possible deregulatory measures
  - government policy development processes to promote competition in these sectors
  - other competition advocacy in relation to concurrent sectors
22. The case management approaches adopted to market studies will be reviewed, including, for example, approaches taken to the use of information requests and other evidence gathering mechanism, and to stakeholder engagement. Particular attention would also be given to ways in which the potential for existing regulatory and legislative provisions to restrict or distort

the development of competition have been considered. Any lessons learned would be identified.

*(3) Developing integrated performance*

23. The use of information sharing, secondments, joint training arrangements, and other mechanisms for delivering more effective knowledge and skills base will be reviewed, and lessons learned will be identified.

**Next steps**

24. We welcome comments on this approach, and on other factors that it may be appropriate to consider as part of this assessment in future years. In particular we are interested in:
- comments on the appropriate format of the report
  - suggestions for the information it would be most useful to include (having regard to the requirements in Schedule 4, paragraph 16, to the ERRA13 and to the points in paragraphs 3.55 to 3.62 of the CMA's *Guidance on concurrent application of competition law to regulated industries*)
  - serious submissions (eg reasoned, supported by relevant evidence, etc) about issues to be raised in strategic dialogue between the CMA and sectoral regulators, including submissions on whether it is more appropriate to apply competition or direct regulatory powers in specific cases or specific markets or sectors.
25. Comments and suggestions should be addressed to: Michael Grenfell, Senior Director, Sectoral Regulation and Concurrency, Competition and Markets Authority – [michael.grenfell@cma.gsi.gov.uk](mailto:michael.grenfell@cma.gsi.gov.uk) . The CMA may seek further clarification on those comments or suggestions as appropriate from individual sectoral regulators.

## B. The approach of the CMA

26. Regulated sectors are typically key parts of the economy that:
- provide essential services to virtually all private consumers and businesses – for example, water, gas, electricity, the NHS
- or
- are essential parts of the ‘infrastructure’ of the economy – such as communications (including telecoms, broadcasting and postal services), railways, airports and air traffic control, and financial services.
27. Many of these were nationalised monopolies until the 1980s and 1990s, while others have operated, for various reasons, other than through a fully competitive market. Sometimes this is because they were (or were understood to be) ‘natural monopolies’ not susceptible to market competition.
28. These are key sectors of the economy – providing essential services to households and businesses – and representing some 25 per cent of GNP.<sup>15</sup>
29. *Direct regulation to protect consumers:* It is for these reasons that these sectors have been subject to direct regulation (sometimes called ‘ex ante regulation’) under which, because it has been thought that the normal protections for consumers that are offered by a competitive market – such as downward pressure on prices, upward pressure on quality, spurs to efficiency and innovation – were not available or at least not sufficient, those kinds of protection for consumers have been achieved, at least in part, by a statutory regulatory regime. Typically there is a sectoral regulator (Ofgem for gas and electricity, Ofwat for water and sewerage, Ofcom for telecoms, broadcasting and other electronic communications as well as post, and so on<sup>16</sup>) charged under statute with enforcing licence conditions, or other regulatory provisions, which are designed to maintain service standards, enhance efficiency, curtail the abuse of monopolistic or market power and in some cases control pricing. Part of the intended function of the regulatory regimes was, therefore, to serve as a proxy for market competition.<sup>17</sup>

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<sup>15</sup> Speech by Lord Currie, Chairman of the CMA, ‘Preventing and reducing anti-competitive activities – a UK perspective’, Chatham House conference, London, 24 July 2013.

<sup>16</sup> See footnote 3 above for a list of the sectoral regulators.

<sup>17</sup> The CMA recognises of course that this is just *part* of the intended function of sectoral regulation, and that there is a wide range of other objectives reflected in the range of statutory duties that apply to each sectoral regulator such as, for example, the protection of low-income households, the imposition of universal service obligations, and environmental protection. Clearly such considerations will inform a sectoral regulator’s decision (in connection with its duty under the ERA13 as described above), to be made before it uses its direct regulatory powers, as to whether it would be more appropriate to proceed by using their powers to apply the UK and EU prohibitions on anticompetitive agreements or abuse of a dominant position.

30. *Direct regulation to promote competition:* Direct ('ex ante') regulation has also been used by many of the sectoral regulators to open up the sectors to market competition. Owners of natural monopoly infrastructure have been required under the regulatory regimes (and in some cases under EU liberalisation legislation) to open up access to that infrastructure to third party competitors on fair and non-discriminatory terms to retail competitors of the traditional retail provider. This has been the case, for instance, for electricity and gas distribution networks, for telecoms networks where there is significant market power or where it is necessary to ensure adequate access and interconnection, for the rail network (through the access regime including for open access passenger and freight train operators) and for the water delivery infrastructure (through arrangements for common carriage, bulk supply and so on).
31. *The development of regulated sectors into increasingly competitive markets:* It is a tribute to the work of the sectoral regulators that many markets which were previously thought inherently incapable of offering consumers the benefits of market competition have over the past few decades matured to a degree that they are now, increasingly, able to do so. Consumers expect a choice of gas or electricity suppliers, and are dismayed if they feel there is insufficient competition in those sectors (previously thought to be natural monopolies). So too with water, where large business users have in recent years increasingly enjoyed competition between suppliers, and all business/non-domestic users are on the brink of benefiting from the ability to choose their supplier for a wider range of water and sewerage services. In telecoms and other forms of electronic communication (increasingly convergent with one another), competition is now taken for granted to such an extent that people barely remember the time when telephony was a state monopoly service on which they were wholly dependent to obtain telecoms services and in which they could exercise virtually no consumer choice. Technology has played a role in this, too; users of BT's services know that there are a variety of alternative providers of the same services or broadly comparable alternatives – whether cable, mobile telecoms or VoIP services (regardless of whether or not these are direct competitors in the same relevant economic 'market').
32. *The role of competition law:* Reflecting these trends – the increasingly competitive nature of previously monopolistic or quasi-monopolistic sectors – the question has arisen of whether, in certain circumstances, lower prices, enhanced quality, and spurs to enhanced efficiency and innovation can more effectively and appropriately be achieved by normal competitive processes as they are in other 'normal' parts of the economy that were not previously monopolies, including the application of normal competition law to correct

anticompetitive practices and market abuses. In most of the regulated sectors, the role of competition has long been recognised, reflected in the fact of most of the sectoral regulators having had concurrent competition law powers for many years;<sup>18</sup> the current reforms in the ERRA13 are designed to enhance the arrangements for the concurrent application of competition law in the regulated sectors, including through making provision for strengthening the primacy of general competition law.<sup>19</sup>

33. A key insight here is that both competition law and direct regulation can have a role in promoting competition – and that direct regulatory powers can dovetail with competition law powers to achieve pro-competitive outcomes. Sectoral regulators use both competition law and direct regulatory powers to promote market mechanisms to further the interests of consumers. Direct regulation has already been effective in opening up regulated sectors to greater market competition (such as by mandating access to networks or requiring cost transparency between upstream and downstream functions in the value chain), and we envisage that it will continue to play an important part in doing so. The competition law and direct regulatory regimes, therefore, can serve as different, but compatible and consistent, means for achieving the same fundamental, pro-competitive, outcomes.
34. Sectoral regulators grapple with these issues all the time in deciding which powers to apply so as to maximise consumer welfare. To take just one specific example: in the rail sector, for instance, the ORR, consistently with its statutory duty to promote competition in the provision of railway services,<sup>20</sup> in November 2013 launched a competition investigation into the carriage of freight by rail based on a suspected infringement of the competition law prohibitions on anticompetitive agreements and abuse of a dominant position – starting with a site visit involving both the ORR and OFT officers. But the ORR has also sought to fulfil that duty to promote competition through other means; in May 2013, the ORR’s statutory duty to promote competition in the provision of railway services for the benefit of railway users was key to the ORR’s decision to approve an application made by the open access operator, Grand Central, to introduce an additional service in competition with the incumbent franchised operator.
35. The CMA will work with the sectoral regulators, through the UKCN and other forms of strategic dialogue, to help achieve an appropriate balance between competition law and other powers in promoting competition for the benefit of consumers.

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<sup>18</sup> See below, footnote 26.

<sup>19</sup> UK Competition Network, Statement of Intent, 2 December 2013, Annexe 1.

<sup>20</sup> Railways Act 1993, section 4. This is one of a number of statutory duties that the ORR has.

## International dimension

36. How best to protect and further consumers' interests in these key sectors is a common concern in many countries across Europe and elsewhere, where legislators and policymakers seek to achieve a proper balance between direct regulation and the application of normal competition law, and to achieve greater competition in those markets (EU liberalisation measures have often played a significant role in this too).
37. There are also questions of the best institutional structure to achieve this. To take a recent example, in Spain in 2013 the national competition authority, the CNC, has been merged with several sectoral regulators (responsible for the telecoms, energy, rail, postal, audiovisual and airports sectors) into a new unitary authority, the CNMC (National Markets and Competition Commission) which will have the hybrid functions of enforcing competition rules and directly regulating economic sectors.<sup>21</sup> In the UK, by contrast, the Government reached a different conclusion – namely that the principal competition authority and the sectoral regulators should retain their independence and that the sectoral regulators should retain the powers to apply competition law (but with measures for greater co-operation between them) on the grounds that:

This will continue to allow the integrated application of sectoral and competition law powers, the application of the sector regulators' industry expertise and ongoing sector surveillance to competition cases, and avoid regulated businesses habitually having to deal with two separate bodies with different objectives and approaches when competition issues arise. It will also avoid causing the regulators to rely even more heavily on their sector-specific powers than they do now to fulfil their duties, as they would not have access to ex-post competition powers.<sup>22</sup>

## EU context

38. Regulation in a number of these sectors takes place in the framework of applicable EU legislation, and in particular sector-specific packages of liberalisation directives designed to open markets to competition. This is particularly true in the case of the electronic communications, energy and rail sectors, where EU legislation not only sets out minimum requirements for opening markets to competition and requiring that competitors have access to monopoly infrastructure historically owned by the legacy provider, but also to

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<sup>21</sup> [http://ec.europa.eu/competition/ecn/brief/03\\_2013/es\\_cnmc.pdf](http://ec.europa.eu/competition/ecn/brief/03_2013/es_cnmc.pdf).

<sup>22</sup> Department for Business, Innovation and Skills, Growth, competition and the competition regime – Government response to consultation, March 2012, paragraph 8.13.

an extent prescribes the modes by which national regulatory authorities can exercise powers in their sectors. The CMA is conscious that regulators' measures to promote competition or make markets work more effectively must be subject to the legal requirements of such EU legislation.

39. Separately, as regards competition law in the regulated sectors, the sector regulators' concurrent powers to apply the competition prohibitions (on anti-competitive agreements and on abuse of a dominant position) relate to those prohibitions both under UK national law and, to the extent that the matters concerned 'may affect trade between Member States' of the EU, under EU law too. Case law of the EU Court of Justice (including the EU General Court) and, to a lesser extent, decisional practice of the European Commission, in respect of the EU prohibitions has implications for the way in which both the CMA and the sectoral regulators exercise those powers.<sup>23</sup>

### **The new measures to enhance competition law in the regulated sectors**

40. Parliament, in passing the ERRA13, has introduced a number of measures to enhance the role of competition law in the regulated sectors, as described above. These measures, which take effect from 1 April 2014, are summarised in paragraph 5 above. Each of the measures is important in itself. Taken cumulatively they represent an attempt to enable competition, and competition law, to play a greater role in the regulated sectors – reflecting the realities of these sectors becoming increasingly capable of offering market competition (and thus more akin to other parts of the economy where competition law, but not direct sector-specific regulation, applies) and the intention of Parliament to enhance the 'emphasis on early and proper consideration of the use of anti-trust powers (under Part 1 of the CA 1998<sup>24</sup>) by the sector regulators'.<sup>25</sup>

### **Continuity as well as change**

41. It is important to keep in mind that this is not 'year zero' as far as competition in the regulated sectors is concerned. The ERRA13 certainly makes changes to the concurrency arrangements that are, as described above, designed to enhance the concurrency arrangements and strengthen the primacy of competition law. But we are not moving from a situation where until now the sectors were wholly subject to direct ('ex ante') regulation, to the exclusion of

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<sup>23</sup> See, in this connection: Council Regulation (EC) 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles [101] and [102] of the Treaty, OJ 2003 L1, especially Articles 1, 2, 3, 5, 11, 12 and 35; and the Competition Act 1998, section 60. The CMA and the sectoral regulators having concurrent competition law powers are designated national competition authorities for the purpose of Council Regulation (EC) 1/2003.

<sup>24</sup> That is, the provisions in the Competition Act 1998 containing the prohibitions on anticompetitive agreements and on abuse of a dominant position.

<sup>25</sup> Enterprise and Regulatory Reform Act 2013 – Explanatory Notes, paragraph 370.

competition law – and we are not moving to a situation where, from now on, these sectors will be wholly subject to competition law with no role for direct regulation. There is continuity as well as change.

42. Competition law has played an important role before now in the regulated sectors:

- *The prohibitions on anticompetitive agreements and abuse of a dominant position:* Most of the sectoral regulators have long had concurrent powers to apply the competition law prohibitions on anti-competitive agreements and abuse of dominance – in many cases since the UK prohibitions came into force in 2000.<sup>26</sup> They have held these powers concurrently with the principal UK competition enforcement authority – the OFT until March 2014, the CMA from April 2014 onwards. Indeed, some regulators have even had, before now, an obligation – similar to the one now being introduced for almost all the sectoral regulators under the ERRA13 – to consider competition law powers before exercising direct regulatory powers.<sup>27</sup>

In practical terms, there has been effective use by at least some of those sectoral regulators of their powers to apply the competition law prohibitions. Others have used these powers relatively rarely, sometimes because they have considered that using their licence powers is more effective and perhaps sometimes because competition has had a lesser role in the sectors concerned (or, at least, was believed to have a lesser role). There is also a risk of a vicious circle, with at least some regulators possibly becoming reticent about applying competition law because they lack sufficient experience, but that reticence impeding their ability to acquire experience.

- *Market studies and investigations:* The sectoral regulators have also had, as described above, powers to conduct market studies or reviews into

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<sup>26</sup> Such powers have been held since 2000 by the CAA in respect of air traffic services, by Ofcom (or rather its predecessor OfTel) in respect of telecoms, by Ofgem (or rather its predecessors the gas and electricity regulators) in respect of energy, by the ORR in respect of railway services and by Ofwat in respect of water and sewerage services. The CAA acquired such powers in respect of air traffic control services in 2001 and in respect of airport services in 2013, Monitor acquired them in respect of health care services in England in 2013, and the Financial Conduct Authority (and the new Payment Systems Regulator) will acquire them in 2015.

<sup>27</sup> For example:

- the Communications Act 2003 section 317(2) provides that, before Ofcom exercises any of its Broadcasting Act 1990 and 1996 powers for a competition purpose, it must consider whether a more appropriate way of proceeding would be under the Competition Act 1998
- the Railways Act 1993 section 55(5A) provides that the ORR is relieved of its duty to take enforcement action by way of a provisional or final order 'if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998'
- the Gas Act section 28(5) and the Electricity Act 1989 section 25(5) provide that 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 Competition Act 1998.

aspects of their sectors and refer them for full market investigation by the Competition Commission (whose market investigation functions will now be the responsibility of the CMA).

In practical terms, this has proved effective; and the opening up of gas, telecoms and airports to competition has resulted from the application in those sectors of this aspect of competition law. For example, in 1997 the production and wholesale businesses of British Gas, previously vertically-integrated, were separated from its retail business following interventions by the competition authorities in 1988 to 1992 which had required only functional separation (on an arm's length basis) between its gas transmission and retail activities so as to facilitate competition at retail level;<sup>28</sup> in 2005, in the light of a decision by Ofcom to make a market investigation reference to the Competition Commission, BT (formerly British Telecom) offered Ofcom formal undertakings, in lieu of such a reference being made, that it would ring-fence its retail arm from its wholesale arm (the latter being renamed Openreach) and ensure retail competitors equality of access to its wholesale offering;<sup>29</sup> and in 2011–13 competition was created between the three London airports Heathrow, Gatwick and Stansted, which had all previously been controlled by one company, BAA, but which are now each owned by three separate companies in accordance with the requirements of the Competition Commission following a market investigation – and also, as a result of the same Competition Commission investigation, between Glasgow and Edinburgh airports, previously both owned by BAA, but now under separate ownership.<sup>30</sup>

43. By the same token, direct regulation will continue to have a role in those parts of the regulated sectors where a competitive market is simply not feasible at this stage (for example, gas transmission pipelines will continue to be a natural monopoly) or where direct regulation is better able than competition law to achieve competitive outcomes. Direct regulation by licence enforcement (or other regulatory measures) can sometimes, for example, produce competitive outcomes more quickly or efficiently than competition law. Moreover, there is empirical evidence that third-party access to monopoly networks, ie allowing downstream competitors of the incumbent operator access to a network owned by that operator – which can be achieved by the

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<sup>28</sup> Monopolies and Mergers Commission, *Gas* (monopoly inquiry report), Cm 500, October 1988. See also Ofgas, *Annual Report* 1991 (1991a).

<sup>29</sup> Ofcom, Final Statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002, 22 September 2005.

<sup>30</sup> Competition Commission, *BAA airports market investigation – A report on the supply of airport services by BAA in the UK*, 19 March 2009; and Competition Commission, *BAA market investigation – Consideration of possible material changes of circumstances*, 19 July 2011.

competition law prohibition on abuse of a domination position (especially the ‘essential facilities’ doctrine), or by UK and EU direct regulation mandating third-party access on reasonable terms – is more effectively achieved by direct regulation. For example, when New Zealand sought to rely solely on competition law following the introduction of the Commerce Act in 1986, there were concerns about excessive reliance on courts and the lack of a clear framework for utilities to work in, particularly as regards pricing – with the result that in the period 2002 to 2004 New Zealand introduced sector-specific direct regulation of its telecoms and electricity sectors, resulting in a mix of competition and direct regulation that now closely mirrors the UK position.<sup>31</sup> Similarly, in Germany, there was widespread criticism of the regime for network access charges in monopoly utilities such as electricity, which at one stage was left as a matter for the competition authorities rather than being prescribed by direct regulation,<sup>32</sup> following which the EU’s second electricity and gas directives led to the establishment of the German regulatory regime ensuring network access in the sectors.

### **Applying the new regime – benefits for consumers**

44. It is the CMA’s statutory duty to promote competition for the benefit of consumers.<sup>33</sup> Where the CMA has a role in connection with the new competition duties on the sectoral regulators (described above), the CMA must exercise its role fulfilling its own statutory duty to seek to promote competition for the benefit of consumers.<sup>34</sup>
45. The CMA wishes to see markets in the regulated sectors (as elsewhere in the economy) working well, in the interests of consumers, businesses, and the economy. It is one of our main goals to extend the frontiers of competition into new areas.
46. The CMA, as noted above, recognises the valuable role of direct regulation by sectoral regulators as furthering the interests of consumers, both in promoting competitive outcomes (for example, in mandating access to incumbents’ networks) and in otherwise protecting consumers (whether by controlling prices or by upholding quality service standards). Moreover, acting by licence enforcement can be the most efficient way of achieving these ends. The CMA

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<sup>31</sup> Paula Rebstock (New Zealand Commerce Commission), ‘The New Zealand experience in utility regulation’, speech at Australian Competition and Consumer Regulatory conference, 30 July 1994. See also Ed Richards (Chief Executive of Ofcom), ‘The complex regulatory environment in the communications sector’, speech at the UCL Jevons Institute for Competition Law and economics, 7 July 2010.

<sup>32</sup> Ger Brunekreeft, *Regulation and competition policy in the electricity market: economic analysis and German experience*, April 2002, pages 231–244.

<sup>33</sup> ERA13, section 25(3).

<sup>34</sup> The duties of the sectoral regulators as regards competition are described in more detail in each of the sector Chapters C to J of this report.

is also conscious of sectoral regulators' wider range of duties in support of other public interest objectives.

47. Yet the CMA also sees an increased role for competition law in the regulated sectors as beneficial for consumers (by way of downward pressure on prices, upward pressure on quality standards and spurs to innovation) and also – through enhanced efficiency, lower costs and improved quality – for the economy as a whole. Specifically, the CMA considers that the exercise of competition law powers can, in certain circumstances, have certain general advantages over direct regulation – including that, for example:

- the use of competition law can encourage participants in a sector (including the parties to an allegedly anticompetitive practice and those who are complaining about it) to think in terms of the actual *effects* on the market of the practice concerned, rather than being directed by the 'black letter' of direct regulatory provisions such as licence conditions, rule books, regulatory codes and agreements or specific regulations
- competition law is often more flexible and can be more sensitive to the changing economic reality of the situation than an ex ante set of prescribed rules that are only periodically reviewed
- the application of competition law in these key sectors creates a body of competition law precedent applicable across regulated sectors and more widely in the economy

48. At the launch of the CMA as a legal entity, on 1 October 2013, the CMA's Chief Executive Alex Chisholm highlighted this as one of the five strategic goals of the new Authority:

we will look to extend the frontiers of competition into new areas. We can use the enhanced markets regime and our other powers to help us address new or rapidly changing markets where business models are evolving; new ways of understanding consumer behaviour; and markets for public services, where the evidence shows that competition and choice can deliver for users, as well as improving cost efficiency. And we have been given a clear remit from government to work with sectoral regulators to ensure fuller use of competition law and policy in sectoral markets.<sup>35</sup>

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<sup>35</sup> Speech by Alex Chisholm, 'CMA mission and strategy', 1 October 2013.

49. This is also in line with the ‘strategic steer’ which the Government issued to the CMA on the same day:

the CMA should engage in a broad strategic dialogue with the regulators and look for opportunities to promote effective competition through either carrying out its own work or actively supporting regulators’ analysis, enforcement and markets activity;

the CMA should work with sector regulators, including the Financial Conduct Authority, to build up its sector capabilities and continuing to share competition expertise, including through joint enforcement work (within the legal framework), training and research

along with the suggestion in the Government’s strategic steer that the specific sectors where increased competition could contribute to faster growth might include ‘financial services and infrastructure sectors including energy’.<sup>36</sup>

50. This approach has been shared by the sector regulators working with the CMA through the new UKCN (UK Competition Network – see above):

The mission of the UKCN will be to promote competition for the benefit of consumers and to prevent anti-competitive behaviour both through facilitating use of competition powers and development of pro-competitive regulatory frameworks, as appropriate.<sup>37</sup>

### **Working with the regulators – a partnership approach**

51. Important as is this approach of increasing the role of competition law in the regulated sectors – for the economy and for consumers – the CMA recognises (as did Parliament) that it is only achievable by the CMA working effectively in cooperation with the sectoral regulators (while having full regard to the views of interested industry players and consumers in the relevant sectors).
52. There is an important principle here, which the concurrency arrangements reflect. In collaboration, the regulators bring their deep knowledge of the sectors for which they are responsible, while the CMA brings its competition expertise, as well the consistency of approach across sectors, both regulated and unregulated. Effective cooperation between the CMA and the sectoral

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<sup>36</sup> Department for Business, Innovation and Skills, ‘Strategic steer for the Competition and Markets Authority 2014-17’, in Annex 1 to its ‘Response to consultation on statement of specific priorities for the CMA’, 1 October 2013, paragraphs 6 and 9.

<sup>37</sup> UK Competition Network, Statement of Intent, 2 December 2013.

regulators, which is enhanced by the ERRA13's changes to the concurrency arrangements, is the best way of making the most of that complementarity, to the benefit of all.

53. The CMA is fully committed to such a partnership approach with the sectoral regulators.

### **In practice: What we are doing to enhance effective cooperation between the CMA and sectoral regulators**

54. The CMA and the sectoral regulators are working on putting in place mechanisms to give practical effect to the enhanced cooperation in concurrency arrangements envisaged under the ERRA13:
- As already noted, under the ERRA13 itself, the Secretary of State is empowered to make regulations on the procedures for allocating cases as between the CMA and sectoral regulators and for the CMA and sectoral regulators to share more information about possible cases under the UK prohibitions<sup>38</sup>
  - Such regulations have already been made, by way of The Competition Act 1998 (Concurrency) Regulations 2014, which (i) establish mechanisms for allocation of cases, (ii) require the establishment of information sharing arrangements and (iii) facilitate the secondment of staff for competition case work as between the CMA and sectoral regulators<sup>39</sup>
  - In addition, the CMA has published *Guidance on concurrent application of competition law to regulated industries*<sup>40</sup> which sets out practical arrangements for case allocation and case handling, and more detailed arrangements are being agreed bilaterally between the CMA and each sectoral regulator, and in many cases have been or will be recorded in a memorandum of understanding
55. The CMA and the sectoral regulators have, in addition, established the UK Competition Network (as described above) – an enhanced forum for cooperation to enable them to work together to ensure the consistent and effective use of competition powers across all sectors.

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<sup>38</sup> ERRA13 section 51.

<sup>39</sup> Respectively, regs 4 to 8, 9 and 10 of the Regulations.

<sup>40</sup> CMA, *Regulated industries: Guidance on concurrent application of competition law to regulated industries*, CMA10, March 2014.

56. The cumulative effect of these measures will be to establish a set of arrangements in which it is hoped that, in addition to the applicable legal obligations, effective practical co-operation will take place by way of:
- (a) sharing information, both on cases under way and more generally (subject to legal constraints including confidentiality obligations); it is intended that suitable IT platforms will be developed to facilitate this
  - (b) secondments of staff, for the purposes of individual cases and more generally
  - (c) more general pooling of resources
  - (d) regular meetings at all levels
  - (e) answering specific queries from time to time
  - (f) providing information or advice on a specific sector or market, or an area of competition law or policy
  - (g) providing training on a specific sector or market, or an area of competition law or policy
57. It remains to be seen how these arrangements will work in practice, and no doubt there will be lessons to be learned from the first year in operation. But in any event the CMA is committed to actively supporting sectoral regulators in the application of competition law including, so far as resources permit, by means of secondments of staff, making available resources, training and information sharing (so far as permitted by law). We see this as a two-way process; reflecting the complementarity of skills, the sectoral regulators have much to offer the CMA from their wealth of expertise and experience about their sectors.
- The CMA will, if appropriate, take responsibility for individual cases in the regulated sectors, but in such cases where the CMA leads, the CMA will involve the regulators in the process
  - The CMA will help the sectoral regulators in explaining to industry players and consumers in the regulated sectors how competition law and policy work, and the benefits it can bring to their sector
58. A small but noteworthy instance of this is this baseline annual report. A large part of the document – particularly the sector reports in the following chapters – draws on work produced by the sectoral regulators themselves, liaising closely with the CMA.

## Looking ahead

59. For the CMA as a new authority, and for the enhanced concurrency arrangements, this first year of operation presents a number of challenges as regards competition in the regulated sectors.
60. First, it is important for us and for the sectoral regulators to make substantial progress in establishing these cooperative arrangements on a sound footing, so as to facilitate more effective application of competition law, and the promotion of competitive outcomes and effective markets, across the regulated sectors.
61. Second, as part of that, we aim to improve the enforcement of competition law in these sectors, using our powers efficiently, robustly and effectively.
62. We would expect to report back on progress in these first two aspects – ie assessing how the concurrency arrangements have operated – in successive annual concurrency reports, as required by the ERRA13.
63. Third, we also aim, through strategic dialogue between the CMA and sectoral regulators, including through the UKCN, to identify opportunities for enhancing competition or combating anticompetitive practices in these sectors, and we envisage the pooling of resources referred to above as an important way of identifying such opportunities and seeing if they can be put to good use in the interests of consumers, business and the economy. In that context we would envisage:
  - supporting the sectoral regulators as appropriate in taking forward some of the issues identified in the sector chapters in the remainder of this report
  - when appropriate, considering, alongside the sectoral regulators, issues arising from submissions by interested parties (as referred to in paragraph 24).
64. At the end of each sector chapter in this baseline report (in each case in Section 5, under ‘Looking ahead’), we highlight issues that the relevant sectoral regulators have identified in their annual plan or other published documents as particularly important to achieving competitive outcomes in their sectors, and helping the markets concerned to work more effectively, to the benefit of consumers.

## Sector chapters

65. The remaining chapters of this report deal, in turn, with the regulated sectors for which sectoral regulators have, or will soon have, concurrent powers to apply competition law. For each sector, we set out:

1. General market conditions
2. The direct regulation regime in the sector
  - 2.1 Using direct regulation to promote competition
3. The competition law regime in the sector
  - 3.1 Duty to promote competition?
  - 3.2 Concurrent powers?
  - 3.3 Duty to consider competition law before taking direct regulatory action?
4. Applying competition law in the sector
  - 4.1 Current approach
  - 4.2 Recent competition law cases
  - 4.3 Competition law data 2005 to 2013
5. Looking ahead

## **C. Airport operation services and air traffic services – the CAA (Civil Aviation Authority)**

66. The aviation sector was progressively liberalised during the 1980s and 1990s as a result of both national and EU legislation. In particular, EU legislation removed government controls on the pricing of air transport services and imposed an open access regime for airports in respect of all airlines operating in the EU based on some common licensing requirements.
67. The impact of this legislation has contributed to the transformation of the sector over the last 20 years as a result of new entry and innovation. In particular, low-cost carriers have enjoyed rapid growth. Established airlines have had to adjust by becoming more efficient and making fares more transparent. As a result of competition, consumers now enjoy a significantly larger choice of destinations. Competition has also contributed to a reduction in prices, although these have also been affected by changes in input costs, particularly fuel, and taxes.
68. As a result of these changes, airlines on European routes are not subject to direct economic regulation. Instead airlines have to comply with competition law for which either the CMA or, in some cases given the cross-border implications, the European Commission has responsibility. For routes outside Europe, however, airline competition continues to be restricted by inter-governmental agreements. An important exception is routes between the EU and the USA which are subject to an 'open skies' regime.
69. The Civil Aviation Authority (the CAA) does nevertheless have both competition and sectoral powers for two particular elements of the aviation sector.
- The first sector is airport operation services under the Civil Aviation Act 2012.
  - The second is air traffic services under the provisions of the Transport Act 2000

For each of these sectors the CAA also has specific regulatory functions and operates according to a different set of statutory objectives. These are dealt with separately in turn in Sections C1 and C2 below.

## **C.1 Airport operation services**

70. Airport operation services are, generally, those services provided at an airport (other than air traffic services air transport services or services provided in shops or other retail businesses) which are concerned broadly with the landing, taking off and manoeuvring of aircraft and the processing of passengers and cargo. These services are normally provided by the airport operator. Under the Civil Aviation Act 2012, a person who permits another to access to use land for the purpose of landing, manoeuvring etc is to be treated as providing airport operation services. Airport operation services are also, by virtue of section 68 of the 2012 Act, taken to include provision of surface access to the airport, to passengers and cargo. Accordingly, some aspects of airport access and parking are also the subject of the CAA's concurrent competition law powers.

### **1. General market conditions**

71. Airports compete to supply airlines with airport operation services, seeking to attract airlines to land at and take off from their airport. This is in order to obtain revenue (in the form of landing charges) from the airlines and, as an indirect consequence, to attract passenger 'footfall'. This, in turn, enables the airport to derive greater revenue from car parking charges, rental of retail space, etc.
72. The extent of competition between airports is to some degree determined by geographical proximity – the extent to which a passenger (and therefore an airline) will regard an airport as a reasonable alternative to the nearest airport to his or her point of departure or destination. The connectivity of the airport is also important. The range of connecting flights and services that are on offer at the airport also determine whether it is an attractive place for airlines to take off and land or for passengers to use. Finally, the intensity of competition will also be affected by the degree of capacity available at different airports in any particular geographic area.

### ***Regional airport competition and the de-designation of Manchester airport***

73. The UK has been at the forefront of efforts to extend competition throughout the aviation sector, not only with respect to airlines but also between airports. Under the regime of the Airports Act 1986 the CAA was required to apply price-cap regulation to airports that were 'designated' by the Secretary of State including Heathrow, Gatwick, Stansted and Manchester. Other than Manchester, these airports had been under common ownership by BAA since its privatisation in 1987. However, other smaller airports have not been subject to direct price and service regulation although many were required to

publish cost and revenue data by activity and they were also subject to conduct regulation. Until the late 1980s most regional airports were under direct local authority control and generally served a localised market. Following the Airports Act 1986, many of these airports were reformed into separate companies under the Companies Act and most have seen private investment introduced. (More recently, however, some airports have reverted to direct public ownership.) Regional airports generally have benefited from the development of low-cost carriers and they now offer a range of short- and long-haul routes for business and leisure passengers.

74. In 2008 the Government ‘de-designated’ Manchester airport (ie took it out of the scope of regulated price control). This was on the advice of the CAA that Manchester airport faced effective competition from other airports.

### ***Divestment requirements on BAA following Competition Commission market investigation***

75. The three major airports in London (Heathrow, Gatwick and Stansted) were until quite recently owned and operated by the same corporate group, BAA. This prevented the possibility of competition between them. Following a market investigation by the Competition Commission over the period 2007 to 2009 (reviewed and confirmed in 2011), which concluded that this common ownership prevented competition between those three London airports,<sup>41</sup> BAA was required to dispose of Gatwick and Stansted airports in London. BAA has subsequently sold these airports so that the three main airports serving London are now under separate ownership.
76. The Competition Commission also concluded that BAA should dispose of one of its airports in southern Scotland (Edinburgh or Glasgow). BAA subsequently sold Edinburgh airport. The Competition Commission also noted that the ‘comparatively isolated geographical position’ of Aberdeen airport served to restrict competition. It accepted undertakings in April 2011 for the reporting by Aberdeen of relevant financial information and to consult stakeholders on capital expenditure

### ***Airport market power determinations***

77. The Civil Aviation Act 2012 replaced the regulatory framework of the Airports Act 1986 by a more flexible licensing regime based on a market power test.

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<sup>41</sup> Competition Commission, *BAA airports market investigation – A report on the supply of airport services by BAA in the UK*, 19 March 2009; and Competition Commission, *BAA market investigation – Consideration of possible material changes of circumstances*, 19 July 2011.

78. Under the 2012 Act, as of 1 April 2014 airport operators must hold a licence from the CAA in order to levy charges for airport operation services if the CAA has made a market power determination that three tests are met:
- (a) that the airport operator has, or is likely to acquire, substantial market power in a market;
  - (b) that competition law does not provide sufficient protection against the risk that the airport operator may engage in conduct that amounts to an abuse of that substantial market power; and
  - (c) that for users of air transport services (ie passengers and cargo owners) the benefits of regulating the airport operator by means of a licence are likely to outweigh the adverse effects.
79. The CAA has recently considered whether these three tests are satisfied in respect of the operators of Heathrow, Gatwick and Stansted airports. These three airports had previously been designated by the Secretary of State for detailed price controls under the previous framework of the Airports Act 1986.
80. In January 2014, the CAA concluded that Heathrow and Gatwick airports both had substantial market power, and consequently issued these airports with economic licences which included price conditions. On the other hand, the CAA found that Stansted airport did not have substantial market power in respect of passenger services – and in March 2014 concluded that Stansted airport did not have substantial market power in respect of cargo services either – and accordingly Stansted airport will not be required to hold an economic licence.<sup>42</sup> In a briefing accompanying publication of the January 2014 report, the CAA stated:

A key market change since the last economic regulation review five years ago is that Heathrow, Gatwick and Stansted now all have different owners. New management teams have taken quite different approaches: we have seen significant operational innovation at Gatwick, while Stansted’s new owners have signed long-term contracts with their main airline customers. Although the scope for competition between London airports is limited by capacity shortages, this diversity of management approach can enable innovation and improve passenger experience.<sup>43</sup>

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<sup>42</sup> This was subsequently confirmed on 13 February 2014 when the CAA issued the initial licences for Heathrow and Gatwick.

<sup>43</sup> Civil Aviation Authority, *Economic regulation at Heathrow from April 2014: notice of the proposed licence*, CAP 1138; *Economic regulation at Gatwick from April 2014: notice of the proposed licence*, CAP 1139; and *Briefing: Economic regulation at Heathrow, Gatwick and Stansted*, 10 January 2014. See also Civil Aviation Authority, *Market power determination for cargo services in relation to Stansted – statement of reasons*, CAP 1153, 24 March 2014.

81. It had been the expectation of the Competition Commission, in requiring BAA to dispose of Gatwick and Stansted, that competition between London airports would thereby develop such that Gatwick and Stansted would no longer hold market power, and the Competition Commission ‘strongly support[ed] ... the reduction, and in due course the removal, of regulation, as competition develops’.<sup>44</sup> At the time the Competition Commission did, however, note that ‘there would be a period of time before there could be confidence that competition between separately-owned airports was sufficiently effective to substitute for regulation’.<sup>45</sup> The CAA’s January 2014 announcement shows that, at least as regards Gatwick, this had not yet happened, because of constraints on the ability of airlines to switch from Gatwick to other London airports.<sup>46</sup>
82. In particular, in reaching this decision, the CAA concluded that Heathrow and Gatwick airports must now be considered to operate in different product markets.<sup>47</sup> The CAA found that the capacity constraints at Heathrow were such that, without the prospect of additional capacity, it could not pose a credible constraint on the operations of Gatwick. Likewise the CAA found that Heathrow’s market position was such that, even in the event that an airline were to switch services from the airport, the vacant slots would be quickly back filled given the significant excess demand for airport operation services at Heathrow.
83. The CAA may make a market power determination in relation to any UK airport whenever it considers it appropriate to do so. The CAA may also revisit an existing market power determination if there has been a material change of circumstances. This could mean that, if a deregulated airport were subsequently to be determined to have market power, it could again be subject to price control regulation. In addition, the CAA must carry out a market power determination if asked to do so by the airport operator or by any other person with a material interest in either case at an airport with more than 5 million passengers. There are six airports within this category besides the three London airports that have been subject to a market power determination. In April 2012 Stansted airport asked the CAA to carry out a market power determination for Luton airport. This request was withdrawn in January 2014 before the CAA had commenced detailed work.

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<sup>44</sup> Competition Commission, *BAA airports market investigation – A report on the supply of airport services by BAA in the UK*, 19 March 2009, paragraph 10.344.

<sup>45</sup> Competition Commission, *BAA airports market investigation – A report on the supply of airport services by BAA in the UK*, 19 March 2009, paragraph 6.87.

<sup>46</sup> CAA, *Market power determination in relation to Gatwick Airport – statement of reasons*, CAP 1134, 10 January 2010.

<sup>47</sup> CAA, *Market power determination in relation to Heathrow Airport – Statement of reasons*, CAP 1133, 10 January 2014, paragraph 2.1 and Chapter 4; and *Market power determination in relation to Gatwick Airport – statement of reasons*, CAP 1134, 10 January 2014, paragraph 2.2 and Chapter 4.

## **2. The direct regulation regime in the sector**

84. With respect to the licences set out for Heathrow and Gatwick, the proposed licence condition for Heathrow is a standard price control while for Gatwick the proposed condition will ensure that the airport meets the commitments it has given to airlines about their future charges at Gatwick. The regulatory regime for both airports seeks to promote efficiency and provide incentives for effective use of airport capacity.
85. The CAA is responsible for establishing the initial conditions in any airport licence it issues and for enforcing and modifying those conditions. In performing these functions, the CAA is subject to a general duty to further the interests of users of air transport services. It must do this, where appropriate, in a manner which the CAA considers will promote competition in the provision of airport operation services.

### ***2.1 Using direct regulation to promote competition***

86. Before the Civil Aviation Act 2012, the CAA did not have access to the standard range of regulatory and competition powers available to other regulators. Instead it had a variety of functions and duties under several different pieces of legislation. However, wherever it has been able to do so consistently with its functions and duties the CAA has adopted a competition framework to address market issues. This has been a particular aspect of its regulation of airport conduct under the Airports Act 1986 where the CAA was able, by condition, to remedy the adverse effects of unreasonable discrimination or of exploitative or predatory behaviour. Similar requirements in relation to discrimination are contained in the Airport Charges Regulations 2011 that transpose EC Directive 2009/12/EC.
87. Although this is not expressly competition law, the CAA has since 2006 been considering allegations brought against airports under this legislation within a competition law framework and has assessed complaints accordingly. Recent examples of cases with a competition dimension that have been considered by the CAA under its various sectoral functions and duties are described below.

#### ***(a) Discriminatory airport charges at Gatwick airport***

88. In January 2013, the CAA issued its decision following an investigation of a complaint by Flybe that Gatwick had restructured its airport charges in a way that had unreasonably discriminated against it and other operators of small aircraft at the airport by increasing the proportion of its charges that came

from landing charges, which had a greater relative effect on flights that carried fewer passengers.<sup>48</sup>

89. The CAA found that Gatwick's flat-rate landing charges discriminated against users of small aircraft as they did not reflect the lower direct costs that small aircraft impose on the airport. However, the CAA found that the discrimination was not 'unreasonable' when opportunity costs were taken into account, as Gatwick's objective of increasing the efficient use of its single runway justified its decision to make the changes challenged by Flybe.
90. The CAA considered whether Gatwick's charges would harm passengers, in particular those on regional routes. The CAA found that passengers who wanted to travel to, or from, Gatwick at peak times on routes served by small aircraft might suffer harm either through higher fares or the loss of a service altogether. However, on all but one route alternative daily services were available either by another airline deploying a larger aircraft from Gatwick or from a service to another London airport. Furthermore, even if fares rose or if another peak service was not available, these flights carried a relatively small number of passengers, and the adverse effects would be balanced by benefits to passengers on other routes which used any slots vacated by operators of small aircraft.

*(b) Discriminatory airport charges at Heathrow airport*

91. In 2011, bmi complained to the CAA that, in restructuring its airport charges from 1 April 2011, Heathrow airport had unreasonably discriminated against bmi passengers on domestic services and short-haul airlines. bmi was particularly concerned with Heathrow's decisions to equalise passenger-related charges on domestic, Irish and other European routes, and to continue not to vary landing charges by aircraft weight. In March 2012, the CAA published its provisional conclusion that there was not a sufficient basis to conclude that Heathrow's conduct amounted to unreasonable discrimination.<sup>49</sup>
92. Although bmi decided not to pursue its complaint, Aer Lingus contested the CAA's findings and the CAA subsequently investigated the matter further. After substantial further examination, the CAA issued a final decision in March 2014, finding that Heathrow's landing charges were discriminatory and had an

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<sup>48</sup> CAA, *Investigation under section 41 of the Airports Act 1986 of the structure of airport charges levied by Gatwick Airport Limited – CAA decision*, APD 13, 17 January 2013.

<sup>49</sup> CAA, *Investigation under section 41 of the Airports Act 1986 of the structure of airport charges levied by Heathrow Airport Limited – CAA provisional decision*, 12 March 2012.

adverse effect on Aer Lingus in particular. However, the CAA determined that it was not appropriate to exercise its discretion to impose any remedy.<sup>50</sup>

### **3. The competition law regime in the sector**

#### **3.1 Duty to promote competition?**

93. In performing its functions to set and modify conditions in licences, and to enforce the licence conditions, the CAA is subject to a general duty to further the interests of users of air transport services. It must do this, where appropriate, in a manner which the CAA considers will promote competition in the provision of airport operation services.

#### **3.2 Concurrent powers?**

94. The Civil Aviation Act 2012 also conferred on the CAA concurrent competition powers (including making market references) in respect of airport operation services. These powers became effective in April 2013. In exercising its concurrent powers the CAA may have regard to its sectoral duties under the 2012 Act if the OFT could have regard to the same matters when carrying out its competition functions.

#### **3.3 Duty to consider competition law before taking direct regulatory action?**

95. Under section 46 of the Civil Aviation Act 2012, the CAA is under an obligation, before exercising its direct regulatory powers of licence enforcement, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).

### **4. Applying competition law in the sector**

#### **4.1 Current approach**

96. The CAA has declared its commitment to promoting competitive markets in the sector, declaring in April 2011 that 'one of its four core strategic objectives for the next five years' is:

the goal of improving choice and value for aviation consumers by promoting competitive markets, contributing to consumers' ability to make informed choices, and protecting them where appropriate<sup>51</sup>

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<sup>50</sup> CAA, *Investigation under section 41 of the Airports Act 1986 of the structure of charges levied by Heathrow Airport – CAA final decision*, CAP1174, March 2014.

<sup>51</sup> CAA, *Guidance on the assessment of airport market power*, April 2011, Foreword.

## 4.2 Recent competition law cases

97. The CAA has not conducted any investigations based on its competition prohibition powers, having acquired those powers only in April 2013. However, as noted above, for airports the CAA has been applying its direct regulatory powers within a competition framework.

## 4.3 Competition law data 2005 to 2013

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2005–2013

Number of complaints <sup>52</sup>	1
Number of investigations formally launched	0

Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2005–2013

Number of market studies initiated <sup>53</sup>	0
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## 5. Looking ahead

- Issues in the airport operations services sector that will be a focus of consideration in the year ahead and beyond include developing robust processes and capabilities to deploy its new concurrent competition law powers, so as to ensure that it can choose the most appropriate tool to address competition problems as they emerge.<sup>54</sup>

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<sup>52</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions.

<sup>53</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

<sup>54</sup> CAA, *Strategic plan 2011/16*, updated March 2014, page 44.

## C.2 Air traffic services

### 1. General market conditions

98. Air traffic services consist of both:
- 'en route' services – air traffic control while the aircraft is cruising
  - terminal air navigation services (TANS) – air traffic control as aircraft take off and land at airports, together with associated ground movements support
99. For the en route services, NATS En Route plc (NERL) is the single supplier in the UK's airspace (and over parts of the eastern Atlantic Ocean), and is the only entity currently licensed under the Transport Act 2000. Because of safety considerations, air traffic controllers cannot 'compete' for the ability to provide services to an aircraft in flight. Consequently, en route services have the characteristics of a natural monopoly, and the potential for competition is thought to be only by way of competition 'for' the market.
100. However, for TANS, there is no legal monopoly; until 2019 there is an exemption from licensing for all providers of air traffic services where the service is provided at an airport. Airports – which are the immediate customers of these services – can and do put out TANS to periodic competitive tender.
101. During 2012/13 the CAA undertook a review of the presence of market conditions for the provision of TANS within the UK. This was requested by the Department for Transport under section 16 of the Civil Aviation Act 1982. The analysis was to be conducted pursuant to Annex 1 to the EU Implementing Regulation 1794/2006, which sets out the relevant criteria for the test.<sup>55</sup>
102. The report, published by the CAA in February 2013<sup>56</sup> (see below), showed that, although the largest airports (including the three major London airports) obtain their airport air traffic services from NERL's sister company NATS Services Limited (NSL), there is a degree of actual and potential competition. A number of airports, particularly smaller airports, 'self-supply' these services, while others have appointed or considered appointing suppliers other than NSL. In 2015, Birmingham airport is expected to become the first 'large' airport in the UK (ie having at least 70,000 air transport movements a year,

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<sup>55</sup> That is, a test as to whether the TANS services in a member state are subject to market conditions. The assessment determines the degree of regulation to be applied to these services. A revised version of this Regulation recently entered into force (Regulation 391/2013).

<sup>56</sup> CAA, *Single European Sky – Market Conditions for Terminal Air Navigation Services in the UK: advice to the DfT under section 16(1) of the Civil Aviation Act 1982*, CAP 1004, 28 February 2013.

such that it is subject to the Single European Sky performance scheme) to switch airport service provision from NSL, in its case to self-supply.<sup>57</sup> In addition, a number of sizeable airports will be recontracting for TANS within the next few years.

103. The CAA report did, however, identify certain barriers to new entrants competing effectively against NSL, including limitations on airport operators' tolerance of transitional risks of service provision, the transparency of TANS costs, transparency in the relationship between NSL and NERL, and an airport operator's ability to move to self-supply.
104. The CAA's advice to the Government in its February 2013 report was therefore that the market conditions test was not met in relation to TANS at the relevant airports. The CAA had concerns relating to:
- the lack of public tender and change in suppliers within the contracts
  - NATS's 'deed of a trust of a promise', under which NATS has certain obligations to maintain the pension arrangements of employee air traffic control officers in the event of a sale or transfer of part of NATS's business; this increased uncertainty and restricted labour mobility in the event of the transfer of supplier at an airport
  - the lack of publicly available information around the interface between NERL as the en route provider and NSL (another company within the NATS group) which provides terminal services at many individual airports. This increased uncertainty for bidders around the potential scope of the services and limited transparency over issues of service discrimination.
105. However, the CAA also noted the potential for the market to work better in the future, and advised there may be a need for further assessments where situations change significantly, so the regulatory regime reflects the most up-to-date evidence. The CAA is currently considering its position on the outcome of this analysis having regard to its statutory duties under the Transport Act 2000 to maintain a high standard of safety and, subject to this primary duty, and where it thinks appropriate, to promote competition in the provision of air traffic services in the interests of users.
106. The CAA's February 2013 report does not have the status of a market study under the Enterprise Act and was not set up as a formal competition investigation. The CAA would have to conduct such a market study, or other

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<sup>57</sup> CAA, *Approach to terminal air navigation service regulation in RP2 – a consultation*, CAP 1132, December 2013.

competition law procedure, in order to take further measures under competition law.

107. If competitive conditions cannot be demonstrated, TANS will continue to fall within the scope of the full requirements of EU Regulations 390 and 391/2013. These require the CAA to oversee the cost and efficiency of providers of TANS and to set performance targets in this respect including EU-wide requirements.

## **2. The direct regulation regime in the sector**

108. The CAA is responsible for, where appropriate, enforcing and modifying the conditions in NERL's licence.
109. In performing these functions the CAA is subject to an overriding duty to maintain a high standard of safety in the provision of air traffic services. Subject to this primary duty, the CAA also has a number of other (secondary) duties – including a duty to further the interests of owners and operators of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in cargo carried in aircraft. In meeting that secondary duty the CAA may further user interests, where appropriate, by promoting competition in the provision of air traffic services.
110. So far as it appears practicable to do so with a view to facilitating the exercise of its statutory functions, the CAA must keep under review the provision of air traffic services.
111. The UK regulation of air traffic services, particularly in relation to price controls and service quality, has increasingly become subject to the framework of regulation of these services that has been developed at a European level as part of the Single European Sky initiative and in particular EU Regulation 391/2013.

### ***2.1 Using direct regulation to promote competition***

112. To date, the CAA has not sought to use direct regulation to extend competition in either the TANS sector or for en-route services.
113. For en-route services, after an initial ten-year period of licence exclusivity, it would now be open to the Secretary of State to license another provider of en-route services alongside NERL, but this has not occurred. (The NERL licence currently allows the Secretary of State to revoke the licence at any time after 2031, on giving at least ten years' notice. In 2011, the Government consulted on requiring this to be at least 25 years' notice, but with the right to serve that

notice at any time, but no conclusions have yet been reached.<sup>58</sup> The licence can also be revoked sooner in circumstances described in the licence.)

114. With respect to TANS, it could be open to the CAA to propose licence changes as a result of any future market study under the Enterprise Act 2002. These could, for example, be based on undertakings provided by NSL in lieu of a full reference to the CMA.

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

115. The CAA's powers with respect to air traffic services are governed by the Transport Act 2000. This requires the CAA (as a secondary duty) to further the interests of owners and operators of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in cargo carried in aircraft. It may fulfil this duty, where appropriate, by promoting competition in the provision of air traffic services.

#### ***3.2 Concurrent powers?***

116. Since 2001 the CAA has had concurrent competition powers with the OFT (under both the competition prohibitions and the market provisions) in respect of air traffic services. In exercising the competition prohibition powers under the Competition Act 1998, the CAA may have regard to its sectoral duties in the Transport Act 2000. The CAA may also have regard to its more general duties in section 4 of the Civil Aviation Act 1982 if the OFT could also have regard to those same duties when performing its concurrent competition functions.
117. Where the CAA is exercising its concurrent powers under the market provisions in the Enterprise Act 2002, it is bound by its sectoral duties.

#### ***3.3 Duty to consider competition law before taking direct regulatory action?***

118. From April 2014, the CAA will, as a result of Schedule 14 to the ERA13, be under an obligation, before exercising its direct regulatory powers of licence enforcement, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).
119. However, under the Transport Act 2000 the CAA was already prevented from exercising its enforcement powers if it was satisfied that the most appropriate way of proceeding was under the Competition Act 1998.

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<sup>58</sup> Department for Transport, *Call for evidence: Extension of the licence period and changes to the terms of NATS (en route) Ltd (NERL)'s air traffic services licence*, 1 September 2011.

## **4. Applying competition law in the sector**

### **4.1 Current approach**

120. For air traffic services, although the CAA has had concurrent competition powers since 2001, it has not had reason to exercise them. During that time, a question that has arisen is whether providers of air traffic services, whether TANS or en route, are ‘undertakings’ for the purposes of competition law. The CAA’s previous legal advice has been that neither NERL nor NSL were undertakings although the position in relation to NSL as a provider of TANS was less certain. The CAA published guidance on this in April 2006 which said that, for NERL, it would consider using its licensing or its competition powers on a case-by-case basis, and for NSL it would expect to consider any allegations of anticompetitive behaviour using competition law. The CAA recognised, however, that the extent of its powers to apply competition law in this sector might ultimately have to be resolved by the courts.
121. Given the importance of this question for the exercise of concurrent competition prohibition powers, especially given the possibilities of opening up competition in TANS, the CMA considers that this legal question should be revisited as soon as possible. It would be helpful to clarify the status of NERL and NSL under competition law, although ultimately this might require a ruling by the courts.

### **4.2 Recent competition law cases**

122. None (see above).

### **4.3 Competition law data 2005 to 2013**

123. None (see above).

## **5. Looking ahead**

124. Issues in the air traffic services sector that will be a focus of consideration in the year ahead and beyond include whether competition is developing adequately in the provision of TANS (terminal air navigation services), and the scope for overcoming the barriers to entry, as identified in the CAA’s February 2013 report on TANS (referred to in Section 2.1 above).<sup>59</sup>

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<sup>59</sup> CAA, *Single European Sky – Market Conditions for Terminal Air Navigation Services in the UK: advice to the DfT under section 16(1) of the Civil Aviation Act 1982*, CAP 1004, 28 February 2013.

## **D. Communications (broadcasting, telecommunications, spectrum and postal services) – Ofcom (Office of Communications)**

125. The Office of Communications (Ofcom) is the independent national regulatory authority for the UK communications industries, with responsibilities across broadcasting (television and radio), telecommunications, spectrum and postal services.
126. Ofcom's strategy is, among other things, to:
- work for consumers and citizens by promoting effective competition, informed choice and the opportunity to participate in a wide range of communications services, including post
  - secure the optimal use of spectrum, through market mechanisms where possible and regulatory action where necessary
  - provide proportionate protection for consumers and help maintain audiences' confidence in broadcast content
  - contribute to public policy defined by Parliament, including high-quality public service broadcasting and plurality of media ownership

### **Duty to promote competition?**

127. Ofcom's principal duties, set out in the Communications Act 2003, are to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.<sup>60</sup>
128. In relation to postal services, Ofcom's primary duty is to carry out its functions in a way that it considers will secure the provision of a universal postal service.<sup>61</sup> Where it appears to Ofcom that, in relation to the carrying out of any of its functions in relation to postal service, that any of the general duties (including the principal duties set out above) conflict with its duty under section 29(1) of the Postal Services Act 2011 to secure the provision of a universal postal service, Ofcom must give priority to that latter duty.

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<sup>60</sup> Communications Act 2003, section 3(1).

<sup>61</sup> Postal Services Act 2012, section 29(1).

## **Concurrent powers?**

129. Ofcom has powers to enforce the competition prohibitions in the Competition Act 1998 in relation to activities connected with communications matters (including broadcasting, telecommunications and postal services)<sup>62</sup> and to make market investigation references under the Enterprise Act 2002 to the CMA in relation to commercial activities connected with communications matters (including broadcasting and postal services).<sup>63</sup>
130. Postcomm, Ofcom's predecessor as regulator of the postal sector, did not have concurrent powers or duties under the Competition Act 1998.

## **Duty to consider competition law before taking direct regulatory action?**

131. From April 2014, Ofcom will, as a result of Schedule 14 to the ERRA13, be under an obligation, before exercising its powers to enforce regulatory requirements under the Communications Act 2003 or the Postal Services Act 2011, to consider whether it would be more appropriate to proceed under the Competition Act 1998.
132. Even before the coming into force of the ERRA13, Ofcom was prohibited from exercising its regulatory enforcement powers under the Communications Act 2003 and the Postal Services Act 2011 where it decided that a more appropriate way of proceeding in relation to the contravention in question would be under the Competition Act 1998.<sup>64</sup> Ofcom was also obliged, before exercising its competition powers in connection with broadcast licences, to consider whether a more appropriate way of proceeding in relation to some or all of the matter in question would be under the Competition Act.<sup>65</sup>
133. Further, Ofcom more broadly considers whether it is appropriate to exercise Competition Act or direct regulatory powers in relevant cases, subject to the specific requirements of the legislation. In some cases, Ofcom does not have discretion as to the powers it uses, and is required to use its direct regulatory powers.
134. The 2007 EU Recommendation on relevant product and service markets states that electronic communications markets should only be susceptible to direct regulation under the EU framework if either (a) the market is set out in the recommendation (in which case Ofcom is under an obligation to review it)

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<sup>62</sup> Communications Act 2003, section 371.

<sup>63</sup> Communications Act 2003, section 370.

<sup>64</sup> Communications Act 2003, sections 94(10) and 96A(5), and Postal Services Act 2011, section 54 and Schedule 7, paragraph 4.

<sup>65</sup> Communications Act 2003, section 317(2).

or (b) three criteria are cumulatively met.<sup>66</sup> The three criteria are: the presence of high and non-transitory barriers to entry; a market structure that does not tend towards effective competition within the relevant time horizon; and the insufficiency of competition law alone to address adequately the market failure or failure concerned.

135. Therefore, whenever Ofcom reviews a telecoms market it explicitly considers whether direct regulation is necessary and whether relying on competition law would be sufficient.

### Current approach to applying competition law

136. Ofcom considers that Competition Act powers are important in the overall toolkit available to it as an economic regulator, but they have to be viewed and deployed in conjunction with other powers, such as Ofcom's sector specific ex-ante and dispute powers. Ofcom considers that as a national regulator it needs to use a balance of powers to address complex competition problems as appropriate in the interests of competition and consumers.

### Competition law data 2004 to 2013

137. These figures apply to Ofcom's competition enforcement activity in all the sectors for which it is responsible (broadcasting, telecoms and post).

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2004-2013	
<b>Number of complaints<sup>67</sup></b>	19
<b>Number of investigations formally launched</b>	13
<b>Number of those cases in which:</b>	
- information gathering powers were used	13
- powers to enter premises/conduct dawn raids were used	0
- a Statement of Objections was issued	2
<b>Number of those cases that resulted in:</b>	
- an infringement decision	0
- the giving of commitments or undertakings to change conduct	0
- an exemption or clearance decision (or equivalent)	9
- case closure without full resolution	2
<b>Number of cases that are ongoing</b>	2
<b>Number of cases in which the decision was appealed to the CAT</b>	1

<sup>66</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:344:0065:0069:en:PDF>.

<sup>67</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to evidenced complaints received by Ofcom which Ofcom regarded as raising competition law issues under those prohibitions and met Ofcom's guidelines for the submission of formal complaints.

**Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2004–2013**

**Number of market studies<sup>68</sup>**

**Initiated** 3

**Number of studies/reviews that resulted in**

- the giving of undertakings 1

- a market investigation reference to the Competition Commission 1

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<sup>68</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

## **D.1 Broadcasting**

### **1. General market conditions**

138. Broadcasters (with the exception of the BBC, which is funded by a licence fee imposed on households that have televisions) generally compete for advertising revenue, which indirectly involves competing for audience share. In addition pay-TV broadcasters compete directly for subscribers.
139. A key determinant of a broadcaster's ability to compete effectively is access to content produced or held by others which is valued by audiences and hence increases market share. This is particularly true of 'premium' content such as the broadcasting rights to films and to major live sporting events. For this reason, competition for access to content can itself be intensive, and some arrangements restricting access to content (for example, exclusivity) have historically raised competition law issues.
140. Technological developments have resulted in more choice and greater competition in some parts of the market. Digital broadcasting over terrestrial, satellite and cable platforms has permitted a proliferation of television channels and radio stations. Broadcasting over the internet (and on to different devices not traditionally regarded as broadcast receivers, including computers and mobile phones) has changed the dimensions of competition, creating new competitive platforms but also raising potential competition concerns (eg about access to gateways where there is vertical integration between, say, a broadcast provider and the owner or operator of a platform). Other technological developments, notably 'video on demand' which allows viewers (to a greater or lesser extent) to determine when they will see a programme, whereas this had previously been the prerogative of schedulers, change the relations between broadcaster and audience and, accordingly, the competitive dynamics in ways that are still developing.

### **2. The direct regulation regime in the sector**

141. Ofcom's principal duties, set out in the Communications Act 2003, are to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.<sup>69</sup>

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<sup>69</sup> Communications Act 2003, section 3(1).

142. In relation to broadcasting, Ofcom has the power to impose conditions on broadcast licence holders to ensure fair and effective competition in the provision of licensed services or of connected services.<sup>70</sup>
143. Between 2007 and 2010, Ofcom reviewed the pay-TV market in the UK. In the light of that review, it decided in 2010 to refer part of the market (the supply and acquisition of subscription pay-TV movie rights and the wholesale supply and acquisition of packages including core premium movies channels) to the Competition Commission for investigation. In respect of premium sports, before using its direct regulatory powers and in accordance with section 317 of the Communications Act 2003, Ofcom considered whether a more appropriate way of proceeding would be under the Competition Act 1998. Ofcom decided that in this case it would not be more appropriate to proceed under the Competition Act and made a decision under section 316 of the Communications Act 2003 that, in order to ensure fair and effective competition across the pay-TV retail market, it was appropriate to insert conditions into the licences for Sky Sports 1 and 2 requiring Sky to make wholesale offers to rival retail platforms, with maximum prices set in the case of SD versions of the channels.<sup>71</sup>
144. Sky and others appealed against Ofcom's decision on sports to the Competition Appeal Tribunal (CAT), which overruled the Ofcom decision. BT, supported by Ofcom, appealed against the CAT ruling to the Court of Appeal. In February 2014 the Court of Appeal found in BT's and Ofcom's favour and ruled that the CAT decision should be set aside and that the CAT should reconsider the case.

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

145. See paragraphs 128 and 129.

#### ***3.2 Concurrent powers?***

146. See paragraphs 130 and 131.

#### ***3.3 Duty to consider competition law before taking direct regulatory action?***

147. See paragraphs 132 to 136.

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<sup>70</sup> Communications Act 2003, section 316.

<sup>71</sup> Ofcom, *Pay-TV statement*, 31 March 2010.

## **4. Applying competition law in the sector**

### **4.1 Current approach**

148. See paragraph 137.

### **4.2 Recent competition law cases**

#### *Pay-TV – films (movies) market study and market investigation reference – 2010–12*

149. As noted above, in August 2010, Ofcom announced a decision to refer the supply and acquisition of subscription pay-TV movie rights and the wholesale supply and acquisition of packages including core premium movies channels to the Competition Commission for investigation. This reference followed an investigation by Ofcom into the pay-TV market. Under the Enterprise Act 2002, Ofcom can make a market investigation reference to the Competition Commission if it has reasonable grounds for suspecting that competition is not working effectively in a market.

150. In its final report, published in August 2012, the Competition Commission concluded that, although competition in the pay-TV retail market overall remained ineffective, it was nevertheless the case that, as regards first pay movie content (the subject of the reference), Sky Movies, which currently offers the first pay movies of all the big Hollywood studios, was ‘not a sufficient driver of subscribers’ choice of pay-TV provider to give Sky such an advantage over its rivals when competing for pay-TV subscribers as to harm competition’.<sup>72</sup>

#### *Television advertising market*

151. In 2013, following a review of the UK TV advertising trading mechanism, Ofcom considered whether to refer the TV advertising market to the Competition Commission and decided that it would not be proportionate to do so.

#### *Complaint from BT against Sky alleging abuse of a dominant position regarding the wholesale supply of Sky Sports 1 and 2*

152. On 14 June 2013, Ofcom opened an investigation under the Chapter II prohibition on abuse of a dominant position (and the equivalent EU law prohibition) into a complaint from BT which alleges that the terms on which Sky offered wholesale supply of Sky Sports 1 and 2 to BT’s YouView platform amount to an abuse of dominance. The complaint alleges that Sky is making wholesale supply of Sky Sports 1 and 2 to BT’s YouView platform conditional

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<sup>72</sup> Competition Commission news release, ‘CC confirms views in pay-TV movies’, 2 August 2012.

on BT wholesaling BT Sport channels to Sky for retail on Sky's satellite platform.

153. As part of the complaint BT requested that Ofcom should consider whether to grant interim measures relief under section 35 of the Competition Act. On 31 July 2013, Ofcom decided to refuse BT's application for interim measures.
154. Further information is available in Ofcom's Competition and Consumer Enforcement Bulletin.<sup>73</sup>

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<sup>73</sup> [http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw\\_01106/](http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01106/).

## D.2 Telecommunications

### 1.1 General market conditions

155. The electronic communications sector has developed considerably since 1984 with BT's flotation, the establishment of the sector regulator the Office of Telecommunications (OfTel) and the introduction of duopoly competition with the licensing of Mercury Communications. The following year, 1985, saw the launch of two mobile phone networks by Vodafone and Cellnet. In 1991, the Government announced the end of the duopoly policy, including more competition for international calls, introducing number portability and permitting cable TV companies also to offer fixed telecoms services.
156. The sector is now far more competitive than could have been envisaged at the time. Whereas before 1984 BT had a monopoly on the provision telecoms services, it is now one of many competing operators. Partly this is as a result of regulatory intervention, generated both under the UK regime, by the regulator Ofcom and its predecessor OfTel, and under EU legislation. BT has, for example, been required to grant competing providers of retail telecoms services access to and interconnection with its networks and infrastructure on non-discriminatory terms, including wholesale calls, line rental and broadband services, 'unbundling of the local loop' (ie the connection from the local exchange to the premises of household and business consumers) and access to its ducts and poles. There has also been competition law action as when, under threat of a market investigation, BT gave formal undertakings in 2005 to undergo 'functional separation' between its upstream/bottleneck activities and its downstream businesses. The undertakings include obligations and mechanisms to ensure that the division responsible for providing the main upstream inputs which enable other providers to compete against BT downstream (renamed Openreach) is ring-fenced from other parts of the BT business and provides services to BT downstream and its competitors on the basis of Equivalence of Inputs (EOI).
157. But technology has also played a considerable role in the development of competition in the sector. Whether or not they are technically in the same relevant economic market as fixed line telephony, consumers of telecoms services can now make use of a wide range of alternatives such as cable, mobile telecoms and VoIP (voice over internet).

158. In fixed line services, BT, the former monopolist, now accounts at the retail level for just 42 per cent of telephone lines, 39 per cent of voice calls and 30 per cent of residential and small business broadband connections.<sup>74</sup>
159. The functionality of telecoms has developed beyond recognition too – with telecoms devices being used to convey data and images as well as voice – allowing for at least a degree of ‘convergence’ between telecoms, broadcasting and computing. This has fundamentally altered the dynamics of competition in the sector.
160. Because telecoms has become such a competitive sector at the retail level – perhaps more than any of the other ‘industries’ privatised in the 1980s and 1990s and made subject to sectoral regulation – the scope for applying competition law, and relying less on direct regulatory measures such as price controls, has been greater, and Ofcom has been active in applying competition law and acquiring valuable expertise in the field. Ofcom will be able to contribute much of this expertise under the concurrent arrangements, for example through the UK Competition Network.
161. The competition challenges in the sector reflect these changes – ensuring that access to networks is on fair and non-discriminatory terms and prices (rather than creating a ‘margin squeeze’ which makes it impossible for competitors of the network owner’s retail arm to compete profitably), without reducing incentives to invest in new technology and networks; ensuring that the necessary collaboration between competing telecoms operators, for example to allow interconnection (which facilitates a caller on one network contacting a recipient on another network) or to allow efficient sharing of networks and infrastructure, does not result in anticompetitive collusion; ensuring that vertical integration between telecoms providers and ownership of valuable content does not lead to foreclosure of competition at either level; and so on.
162. Analysis by the National Audit Office published in November 2010 suggests that there have many positive outcomes of Ofcom’s regulatory and competition work in the communications sector – for example, prices have fallen and there is better choice and quality. Ofcom’s research shows that customer satisfaction is generally high.<sup>75</sup>

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<sup>74</sup> Ofcom, *Telecommunications market data tables*, Q2 2013m page 5, Tables 2 and 3, and page 16, Table 16: <http://stakeholders.ofcom.org.uk/binaries/research/cmr/telecoms/Q2-2013.pdf>.

<sup>75</sup> Ofcom, *The consumer experience of 2013*, January 2014. See also National Audit Office, *Ofcom: The effectiveness of converged regulation*, 10 November 2010.

## 2. The direct regulation regime in the sector

163. Ofcom is the national regulatory authority under the EU telecommunications framework, with responsibility for giving effect to that framework in the UK. The purpose of the framework is to harmonise the regulation of the telecommunications industry across the EU, and to promote competition where appropriate in the interests of consumers.
164. There are no licences required for telecoms operators (other than in relation to spectrum) but Ofcom has issued 'general conditions' applicable to all communications networks and service providers.

### 2.1 Using direct regulation to promote competition

165. In order to promote competition where appropriate in the interests of consumers, Ofcom has a number of statutory functions which it must carry out. These include:
- (a) the duty to **review markets** to assess whether they are effectively competitive, and, where they are not, to impose direct regulatory ex ante remedies; and
  - (b) the duty to **resolve disputes** between communications providers in order to ensure (among other things) interconnection on reasonable terms.
166. In relation to market reviews, Ofcom has a duty under the EU framework to review markets identified by the European Commission at least every three years, to assess whether they are effectively competitive. That involves examining whether any of the entities in the market have 'significant market power' (SMP) – which the EU framework provides is akin to dominance under competition law – and if so whether any conditions should be imposed on those entities with SMP to address the lack of effective competition identified. Those remedies typically take the form of access obligations, non-discrimination obligations, price controls, transparency (eg publication of reference offers, terms and conditions, technical information and key performance indicators). Where Ofcom intends to impose such remedies, it must first inform the European Commission and other national regulatory bodies in the EU, because of the harmonising intention underlying the telecoms framework.
167. Ofcom also has the power to take action to enforce communications providers' obligations under regulatory conditions that it has imposed. Ofcom has a discretion as to when to exercise these powers.
168. In relation to regulatory disputes, such disputes often raise issues which could potentially also constitute infringements of the Competition Act 1998. Parties

often choose to refer such matters to Ofcom as disputes rather than as complaints under the Competition Act for reasons which include that:

- (a) Ofcom has a duty to handle certain disputes which relate to regulatory conditions,<sup>76</sup> whereas it has administrative discretion whether to investigate Competition Act cases;
- (b) Ofcom must resolve disputes within a statutory four-month deadline, save in exceptional circumstances, whereas no deadlines apply to Competition Act investigations; and
- (c) Ofcom has a power to require payments between parties to address any under- or over-payments, whereas in Competition Act cases the infringing party may face a fine, but the victim must separately seek damages in follow-on litigation.

169. Although Ofcom has over time been able to deregulate in a number of telecoms markets as they have become effectively competitive, due to the existence of bottlenecks a number of markets still need direct regulation on the incumbent providers to ensure access and pricing on appropriate terms. The effect of imposing direct regulatory remedies in this way reduces the likelihood of Competition Act cases arising, partly because the incumbent operators who are subject to remedies are less likely as a result to be in a position to abuse their dominant position, and partly because the structure of the markets tends to mean that cartel-like behaviour is unlikely.

170. Recent examples of where Ofcom concluded in a market review that direct regulation was unnecessary, either because competition law would be sufficient or because it considered the market is effectively competitive include:

- The fixed narrowband services market review in which Ofcom removed direct regulation in the market for retail residential and business fixed calls in the Hull area and the UK-wide wholesale single transit market (Ofcom had previously made similar decisions relating to the local-tandem conveyance and transit markets, in 2009, and the inter-tandem conveyance and transit markets, in 2005).<sup>77</sup>

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<sup>76</sup> Ofcom also has discretionary powers to resolve other types of specified regulatory disputes – see section 185 Communications Act 2003.

<sup>77</sup> [http://stakeholders.ofcom.org.uk/binaries/consultations/nmr-2013/statement/Final\\_Statement.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/nmr-2013/statement/Final_Statement.pdf).



## 4.2 Recent competition law cases

### *Complaint from TalkTalk Telecom Group plc against BT Group plc about alleged margin squeeze in superfast broadband pricing*

175. On 1 May 2013, Ofcom opened an investigation under the Chapter II prohibition on abuse of a dominant position (and the equivalent EU law prohibition) into matters raised by a complaint from TalkTalk alleging that BT has been abusing a dominant position in relation to the supply of superfast broadband. Specifically, TalkTalk alleges that BT has failed to maintain a sufficient margin between its upstream costs and downstream prices, thereby operating an abusive margin squeeze. Further information is available in Ofcom's Competition and Consumer Enforcement Bulletin.<sup>81</sup>

### *Complaint from Thus Plc and Gamma Telecom Limited against BT about alleged margin squeeze in wholesale call pricing*

176. On 20 June 2013, Ofcom closed an investigation under the Chapter II prohibition on abuse of a dominant position (and the equivalent EU law prohibition) into a complaint from Thus Plc (Thus) and Gamma Telecom Limited (Gamma) alleging that BT's pricing of wholesale end-to-end voice calls to resellers since April 2005 amounts to an abusive margin squeeze.

177. The specific allegations made were that BT's pricing:

- might be below cost
- was aimed at eliminating or weakening competition in the provision of wholesale end-to-end voice calls to resellers by reducing the margin available to Carrier Pre-Selection Operators (CPSOs) when they sell their services to resellers
- would result in CPSOs no longer being able to compete in the market profitably and that a number can be expected to exit the market

BT had previously been found to have significant market power in a number of network access markets.

178. On 21 December 2010, Ofcom sent a Statement of Objections to BT setting out the view that BT may have engaged in a margin squeeze in the market for wholesale end-to-end calls between July 2008 and April 2009.

179. Following further written and oral representations, Ofcom issued a detailed 'no grounds for action' decision, concluding that despite negative margins being earned, there was no evidence of material negative effects on competition.

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<sup>81</sup> [http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw\\_01103/](http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01103/).

180. Further information is available in Ofcom's Competition and Consumer Enforcement Bulletin.<sup>82</sup>

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<sup>82</sup> [http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw\\_988/](http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_988/).

## D.3 Spectrum

### 1.1 General market conditions

181. The radio spectrum is a finite resource, essential for modern communications (as well as for the effective operation of, for example, the armed forces, emergency services and safe and efficient transport systems).
182. There is ever-growing demand for spectrum, particularly in frequency bands that are suitable for mobile and wireless communication, reflecting the increasing usage of mobile telecoms and the types of use to which mobile devices are put. Timely access to spectrum free from unnecessary technical restrictions is essential to allow innovation and investment.
183. At the same time, however, spectrum use has to be planned and managed to prevent radio signals from interfering with each other. Historically, that involved the regulator imposing detailed restrictions on how the services provided and technologies could be used. Licences traditionally imposed a variety of restrictions, depending on the service, typically including the application to which the spectrum was to be put (eg mobile, point-to-point terrestrial links and type of business), the use to be made of the spectrum and the technology to be employed.
184. In recent years Ofcom has introduced measures to enhance efficient use of spectrum while being careful that such measures do not result in harmful interference between radio signals. There have also been moves at EU level in this direction. In particular, Ofcom has used three key mechanisms to fulfil its duty to secure the optimal use of radio spectrum:
- Carrying out auctions for the award of spectrum licences. In designing the auction process, Ofcom has regard to its duties and, where appropriate, includes measures aimed at promoting competition.
  - Spectrum liberalisation – that is, the regulator being less prescriptive about the application, use and technology linked to any block of spectrum licensed, allowing greater flexibility and more efficient use of the resource. For example, over the past few years, Ofcom has varied a number of spectrum licences to allow use of the spectrum for LTE and WiMax technology – in effect for 4G ('fourth-generation') technology usage.<sup>83</sup>

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<sup>83</sup> Ofcom, *Decision to vary Everything Everywhere's 1800 MHz spectrum licences to allow use of LTE and WiMax technologies*, statement, 21 August 2011, and Ofcom, *Statement on the Requests for Variation of 900 MHz, 1800 MHz and 2100 MHz Mobile Licences*, statement, 9 July 2013.

- Spectrum trading. Ofcom has gradually introduced spectrum trading, initially allowing trading only for relatively 'peripheral' activities such as the use of pagers, remote meter reading and private business radio, and more recently permitting the trading of spectrum used for mobile telecoms.

## **2. The direct regulation regime in the sector**

185. Ofcom has responsibility for managing UK radio spectrum under the Communications Act 2003 and the Wireless Telegraphy Act 2006. The regulatory regime operates within the framework of EU legislation on electronic communications, as described in Section 1 above.
186. Spectrum rights can, subject to certain licence exemptions, only be held under licences granted by Ofcom. As described above, certain spectrum (including spectrum for mobile telecoms) may now be traded between parties.
187. Subject to Ofcom's principal duties under the Communications Act 2003, as described in paragraph 128, Ofcom has a number of duties specific to spectrum management, including having regard to: availability; current and future demand; promoting efficient management and use; promoting economic benefits; promoting innovation; and promoting competition in electronic communications services.<sup>84</sup>

### **2.1 Using direct regulation to promote competition**

188. An important principle of Ofcom's spectrum management strategy is to rely on market mechanisms where possible and effective to help deliver efficient spectrum allocation and use. Once the conditions required for the use of market mechanisms are in place, they are generally considered to be the most effective method of allocating scarce resources.
189. The measures described in Section 1 above, as well as facilitating the more efficient use of spectrum, can also promote competition in the services (eg mobile telecoms) for which the spectrum is used. In particular:
- market entry or expansion by smaller new players is easier when it is possible to buy spectrum from an existing network operator, or to adapt existing spectrum holdings for other purposes, rather than having to wait for the next auction
  - while acquiring rights to use large blocks of spectrum that are put up for auction can be costly, spectrum trading allows sales of smaller blocks of

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<sup>84</sup> Communications Act 2003, section 154.

spectrum that are more affordable to new entrants or operators wanting to expand

- spectrum trading encourages bidding in spectrum auctions, which can itself be pro-competitive; if the bidding companies know that the danger of having purchased too much and spent too much is mitigated by the possibility that they can on-sell excess spectrum, they may be less inhibited about bidding in auctions

190. Competition interests are also protected in the regime for trading mobile spectrum as Ofcom can refuse to consent to a transfer of such spectrum if competition is likely to be distorted as a result of the transfer.<sup>85</sup>

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

191. See paragraphs 128 and 129.

#### ***3.2 Concurrent powers?***

192. See paragraphs 130 and 131.

#### ***3.3 Duty to consider competition law before taking direct regulatory action?***

193. See paragraphs 132 to 1365.

### **4. Applying competition law in the sector**

#### ***4.1 Current approach***

194. See paragraph 137.

#### ***4.2 Recent competition law cases***

195. None.

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<sup>85</sup> The Wireless Telegraphy (Mobile Spectrum Trading) Regulations 2011 SI 2011/1507 reg 9.

## **D.4 Postal services**

### **1. General market conditions**

196. The postal services market is in a period of fundamental transition. The past year has seen the partial privatisation of Royal Mail (the business that collects and delivers post and parcels, but does not own or operate the network of post office branches), coupled with a new regulatory regime which has removed nearly all of the direct price controls on Royal Mail, given its greater operational freedom, maintained its universal service obligation and made provision for competing postal operators to have access to elements of its delivery network (see below on the direct regulation regime in the sector).
197. The market in which Royal Mail operates has also changed fundamentally. The emergence of the internet has both represented a competitive threat and offered new competitive opportunities to postal operators. Mail volumes have fallen by 27 per cent since 2007 as many written communications which would previously have been sent by post (including documents) are now sent by email or provided online. At the same time, the growth of online shopping has offered new sources of revenue to Royal Mail's parcel services, to competing parcels operators and led to new services such as 'click and collect', where a customer orders goods online which are then delivered to a local shop (often a physical branch of the same company) for collection.
198. Following the enactment of the Postal Services Act 2011, Ofcom began regulating the postal sector on 1 October 2011. Before that, the postal sector was regulated by Postcomm, which was itself established in 2000. There was no sector-specific regulator prior to 2000.

### **2. The direct regulation regime in the sector**

199. In relation to postal services:
- Ofcom's 'principal duties' in the Communications Act 2003 to further the interests of citizens in relation to communications matters (including postal services) and to further the interests of consumers in relevant markets, where appropriate by promoting competition apply when it is exercising its postal services functions<sup>86</sup>

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<sup>86</sup> Communications Act 2003, section 3(1).

- Ofcom’s primary duty under the Postal Services Act 2011 is to carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service<sup>87</sup>
  - Where Ofcom is carrying out its functions in relation to postal services, and it considers that its ‘primary duty’ under the Postal Services Act conflicts with its principal duties under the Communications Act 2003 it must give priority to the primary duty relating to the securing of a universal postal service
200. In March 2012, Ofcom established a new regulatory framework for postal services. In summary, this decision gave Royal Mail greater pricing freedom (including the lifting of nearly all price controls) so it could return the universal service to financial sustainability, subject to certain safeguards. These key safeguards were an effective and ongoing monitoring regime, a safeguard cap on second class stamped items up to 2 kilograms to ensure they remained affordable and competition.
201. Ofcom also has the power to impose various regulatory conditions, including price controls for universal service products and access services. While price controls can be used to imitate the effects of competition, ie by constraining prices and providing incentives for efficiency, the two price controls that Ofcom imposed in 2012 did not have that intention. The first is an affordability cap on second class stamped items up to 2 kilograms. This was intended to ensure that prices remained affordable for consumers. The second is a margin squeeze test to prevent Royal Mail from squeezing access operators.
202. In setting out the new regulatory framework for postal services in March 2012, Ofcom removed nearly all price control obligations from Royal Mail, mindful of the potential for competition law as a safeguard.

### ***2.1 Using direct regulation to promote competition***

203. Ofcom has powers under sections 38 and 50 of the Postal Services Act 2011 to impose access conditions on certain postal operators to require them to give access to their networks to third parties. Schedule 3 to the Postal Services Act 2011 gives Ofcom powers to resolve access disputes in the postal services sector where an access condition has been imposed. As at November 2013, Ofcom had imposed one USP access condition under section 38 of the Postal Services Act 2011, which requires Royal Mail to offer access at the Inward Mail Centre for the provision of D+2 and later than D+2 Letters (ie letters for delivery beyond the next day) and Large Letters

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<sup>87</sup> Postal Services Act 2011, section 29.

services.<sup>88</sup> In effect this continued the access obligation that had previously been applied to Royal Mail by Postcomm. As of March 2013, access represented 47 per cent of total market volumes.<sup>89</sup>

204. On 21 February 2014 Ofcom announced that following a complaint from TNT, Ofcom had decided to open an investigation in relation to certain prices, terms and conditions offered by Royal Mail for access to certain letter delivery services (known as 'D+2 access'). This follows announcements from Royal Mail in November 2013 and January 2014 of changes to these prices, terms and conditions. Ofcom has not yet decided whether it would be more appropriate to proceed under the Competition Act 1998 or the Postal Services Act 2011.

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

205. See paragraphs 128 and 129.

#### ***3.2 Concurrent powers?***

206. See paragraphs 130 and 131.

#### ***3.3 Duty to consider competition law before taking direct regulatory action?***

207. See paragraphs 132 to 136.

### **4. Applying competition law in the sector**

#### ***4.1 Current approach***

208. See paragraph 137.

#### ***4.2 Recent competition law cases***

209. As described above, Ofcom is currently investigating certain Royal Mail prices for access. Ofcom has not yet decided whether it would be more appropriate to proceed under the Competition Act 1998 or the Postal Services Act 2011.

### **5. Looking ahead**

210. Ofcom's draft annual plan for 2014/15 categorises planned work under five strategic purposes, of which the most relevant to concurrency is Ofcom's

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<sup>88</sup> See Ofcom, *Securing the Universal Postal Service: Decision on the new regulatory framework, Statement*, 27 March 2012.

<sup>89</sup> Ofcom, *Annual monitoring update on the postal market: Financial year 2012-13*, page 46: [http://stakeholders.ofcom.org.uk/binaries/post/post/Annual\\_monitoring\\_update\\_2012-13.pdf](http://stakeholders.ofcom.org.uk/binaries/post/post/Annual_monitoring_update_2012-13.pdf).

purpose to promote effective competition and informed choice. Under this strategic purpose Ofcom has identified three priority areas, all of which relate to telecommunications:

- ensure effective competition and investment in both current and superfast broadband
- promote effective choice for consumers by ensuring that clear and relevant information is readily available
- develop and implement policies that will improve the ease of switching between communications providers

211. In addition to these priority areas, Ofcom has also identified the following major work areas for 2014/15:

- in relation to telecommunications, monitor underlying approaches to traffic management to ensure compliance with Ofcom's approach to net neutrality
- in relation to telecommunications, review the framework for regulatory financial reporting in telecommunications
- in relation to broadcasting, work to ensure effective competition in pay-TV services
- in relation to telecommunications, conduct the mobile termination rates charge control review
- in relation to telecommunications, conduct the business connectivity market review

## **E. Electricity and gas in Great Britain – Ofgem (Gas and Electricity Markets Authority)**

212. The Gas and Electricity Markets Authority (Ofgem) is the regulator for the gas and electricity markets in Great Britain and is the designated national regulatory authority for Great Britain under the EU's Third Energy Package.<sup>90</sup> Ofgem is also a national competition authority with concurrent powers with the CMA to enforce competition law in respect of specified activities in energy markets<sup>91</sup> under the Competition Act 1998 and the Enterprise Act 2002.

### **1. General market conditions**

#### ***Structure of the energy markets***<sup>92</sup>

213. The retail energy market is made up of gas and electricity suppliers who buy energy from the wholesale market (including their own upstream businesses where applicable), or directly from producers, and arrange for it to be delivered to the end consumer. They set the prices that consumers pay for the energy they use. They bill consumers and manage all aspects of customer service.

214. Electricity is produced by generators who can use a range of energy sources from renewables such as wind power, through to fossil fuels and nuclear which all have different characteristics. Electricity can also be imported or exported through interconnectors.

215. Gas comes from offshore production facilities and can be delivered through international pipelines or liquefied natural gas (LNG) terminals and can be delivered into or from storage sites which are used to help manage winter or other peaks.

216. Supply and demand for electricity must be matched, or balanced, at all times. National Grid Electricity Transmission as System Operator has overall responsibility for ensuring that electricity supply and demand match on a second-by-second basis. They have a range of balancing actions open to them including bringing on additional generation or, in extremis, curtailing demand. If a supplier consumes more or less electricity than they have contracted for they are exposed to the 'cash out' price for the difference. Similar rules apply to all market participants including generators. The 'cash

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<sup>90</sup> The Third Energy Package comprises a number of EU Directives and Regulations, the majority of which came into force or were to be implemented by member states by 3 March 2011. Directives relating to unbundling were required to be implemented by 3 March 2012, with actual unbundling to take effect before 3 March 2013.

<sup>91</sup> Ofgem's functions with regard to competition are set out in the Gas Act 1986, section 36A, and the Electricity Act 1989, section 43.

<sup>92</sup> This summary of the structure of the energy markets is taken from Ofgem/OFT/CMA, *State of the market report – Assessment framework*, 19 December 2013, paragraphs 2.2–2.13.

out' price is calculated on a half-hourly basis and the detailed rules are set out in the Balancing and Settlement Code (BSC). These rules are designed to provide incentives on suppliers and generators to minimise their imbalances through contracting, operational or investment decisions. Similar arrangements apply in gas where National Grid Gas plc is the System Operator. It has responsibility for ensuring that gas supply matches gas demand on a daily basis.

217. For both gas and electricity, trading can take place bilaterally or on exchanges, and forward contracts can be struck over timescales ranging from several years ahead to on-the-day trading. Suppliers can have a range of 'hedging' strategies and will buy energy on different terms in order to attempt to minimise their costs and avoid unnecessary price volatility. Vertically-integrated companies, which own electricity generation or upstream gas assets as well as supply businesses, can also source energy internally to meet their customers' energy demand.
218. In order to supply gas or electricity a company must generally have a supply licence. Ofgem can amend licence conditions and take enforcement action in the event of any breaches. Suppliers must comply with consumer protection obligations, for example in relation to disconnection or marketing and sales. Ofgem does not set consumer prices.

### ***Development of competition***

219. Following the privatisation of British Gas in 1986 and of the electricity industry in 1989, British Gas and the 14 regional Public Electricity Suppliers (PESs) initially had a monopoly on supply to all domestic gas and electricity consumers respectively in Great Britain. Competition was gradually introduced into the retail energy markets, a process which was completed by 1999 – with retail gas and electricity suppliers being permitted to compete against each other (first, to large energy consumers only, and then subsequently to all energy users) and being granted access rights to the infrastructure. In the mid-1990s, the transmission and retail businesses of British Gas were separated, following interventions by the competition authorities. As the market developed, competition exerted a downward pressure on prices and Ofgem moved promptly to end price controls.
220. The number of suppliers in the retail market subsequently fell to six as a result of horizontal mergers. Some of these businesses also merged with generation companies to create vertically-integrated groups. Today, the six largest suppliers in Great Britain serve around 97 per cent of the domestic retail gas and electricity market, and own around 70 per cent of the generating capacity. In the gas sector, vertical integration is less of a feature; of the six largest

retailers, only Centrica (British Gas) has significant gas production capability as a part of its UK group, with production in 2012 representing around a third of its Great Britain supply requirements for domestic and small and medium-sized enterprise (SME) consumers.

221. Since the start of competition, small suppliers have entered the market and, in the last few years, have secured significant increases in market share.<sup>93</sup> On the domestic side, there are now more than a dozen suppliers serving over 5 per cent of the market, three of whom have more than 100,000 customer accounts. In the non-domestic market, there are a larger number of suppliers than in the domestic market, with a total of 32 suppliers. The six largest suppliers supply 92 per cent of non-domestic non-half hourly electricity sites (85 per cent by volume) and 68 per cent of non-domestic non-daily metered gas sites (33 per cent by volume), which typically belong to smaller businesses.<sup>94</sup>
222. Alongside the development of competition in the retail markets, some ancillary services were also opened up to competition. The former-PES distribution businesses opened some areas of connections work, termed 'contestable work', to competitive providers. In July 2000, Ofgem set out proposals which aimed to accelerate the development of competition in connections to the former PES distribution systems. The scope of contestable work now includes network extensions, including design, provision of materials, testing and installation, and live connections on new networks. Ofgem has continued to monitor the development of competition in the connections market, culminating in its current review of this area.
223. Ofgem has also taken active measures to facilitate competition in gas and electricity metering services since 2000, to promote lower metering costs, better service, accurate billing and encourage innovation and the introduction of smarter forms of metering, with a view to driving down the costs of providing and maintaining conventional and smart meters. Price controls on new installed electricity meters have been removed and there are no price controls on smart meters.
224. The state of competition in the energy sector is currently the subject of considerable public and political interest. In October 2013, the Secretary of State for Energy and Climate Change asked Ofgem to work with the OFT and the CMA to report regularly on competition and the health of the market and to deliver its first assessment by the end of March 2014. On the basis of its

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<sup>93</sup> The market share of small and independent electricity suppliers nearly trebled from January 2011 to August 2013.

<sup>94</sup> Ofgem/OFT/CMA, *State of the market report – Assessment framework*, 19 December 2013, paragraphs 2.10–2.13.

assessment, which was published on 27 March 2014, Ofgem is now proposing to make a market investigation reference to the CMA. The aim of the reference would be to establish if there are market features which are having an adverse effect on competition and, if so, whether there are reforms, including those outside Ofgem's powers, which would make competition in the market more effective.<sup>95</sup>

## 2. The direct regulation regime in the sector

225. Ofgem's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them, and their interests in the fulfilment by Ofgem of certain objectives specified in the EU's Gas and Electricity Directives.<sup>96</sup> Those objectives include:

- promoting a competitive, secure and environmentally sustainable internal market and effective market opening
- ensuring consumers benefit through efficient market functioning and promoting competition and helping to ensure consumer protection
- helping to achieve high standards of universal and public service in electricity supply, and contributing to the protection of vulnerable customers

226. The principal objective is not a freestanding duty; rather, where Ofgem is considering exercising its functions, it is generally required to carry out those functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with:

- the shipping, transportation or supply of gas conveyed through pipes
- the generation, transmission, distribution or supply of electricity

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<sup>95</sup> Ofgem, *Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, page 5:  
[www.ofgem.gov.uk/ofgem-publications/86807/consultationpublish.pdf](http://www.ofgem.gov.uk/ofgem-publications/86807/consultationpublish.pdf).

<sup>96</sup> Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC; Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC.

- the provision or use of electricity interconnectors<sup>97</sup>

227. However, before exercising functions for the purpose of promoting competition, Ofgem has a positive duty to consider the extent to which the interests of consumers would be protected by the promotion of competition and whether alternative ways of exercising its functions would better protect the interests of consumers, such as introducing or enhancing regulatory measures.

### **2.1 Using direct regulation to promote competition**

228. As well as applying competition law, Ofgem also relies on direct regulation to promote competitive outcomes for consumers where appropriate. The relevant framework within which Ofgem operates involves the application of direct regulation in particular areas.

229. Subject to the requirements of the statutory framework referred to above (including the explicit obligation on Ofgem to consider whether means other than competition would protect the interests of consumers), Ofgem seeks to enhance competition in energy markets wherever possible and appropriate. This acknowledges the role that direct regulatory rules can play in developing a properly-functioning competitive market for the benefit of consumers. Moreover, this approach aligns with the stated mission of the UK Competition Network, as set out in Section 2 of its Statement of Intent ('Purpose of the UK Competition Network as agreed by regulatory heads'), to promote competition for the benefit of consumers and to prevent anticompetitive behaviour, both through facilitating use of competition powers and development of pro-competitive regulatory frameworks, as appropriate.

230. There are therefore areas where direct regulation is still required in order to ensure access and prices on appropriate terms, so reducing the likelihood of competition issues arising due to abuse of a dominant position.<sup>98</sup>

#### *EU Third Package – 'unbundling' and network access*

231. In some instances, such regulation derives from EU legislation relevant to energy, including the EU's Third Package. As the national regulatory authority responsible for regulating Great Britain's energy market, Ofgem applies and enforces the rules introduced under the Third Package<sup>99</sup> requiring the separation (or 'unbundling') of networks from activities of production and

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<sup>97</sup> Gas Act 1986, section 4AA(1), and Electricity Act 1989, section 3A(1).

<sup>98</sup> Regulation has a role to play, not only in ensuring access to network assets, but also, in particular, to ensure the safe operation of the system and that it is kept in balance.

<sup>99</sup> Included in the Electricity Act 1989 and the Gas Act 1986 (as amended by the Electricity and Gas (Internal Markets) Regulations 2011).

supply in order to prevent vertically integrated undertakings from discriminating against their competitors as regards to network access and investment.

232. Ofgem also enforces the rules on access to the networks by those who do not own the physical network infrastructure, known as third party access, which were introduced under the Third Package and are designed to facilitate greater competition and make energy markets work effectively. Owners and operators of the electricity networks, the transmission system operator and the distribution system operators, and the owners/operators of interconnectors, are obliged to provide non-discriminatory access to their lines, pipes and other facilities to third parties.

#### *Introducing competition into new areas to benefit consumers*

233. *Wholesale gas and electricity markets:* The wholesale market has been created out of a state monopoly and the various codes and relevant licence conditions have been designed to ensure that this market works more effectively and in the interests of consumers. For example, the Electricity Balancing Significant Code Review aims to ensure that better use is made of existing assets and that there are clearer signals for investment/withdrawal of assets to create a better-working wholesale market; the Gas Emergency Significant Code Review aims to remove the dulling of the incentives to flow gas in the run up to an emergency.
234. *Liquidity proposals:* Ofgem consulted in 2013 on proposals to increase access to the wholesale market for small suppliers, following concerns that poor liquidity poses a barrier to effective competition.<sup>100</sup> Following that consultation, new rules came into force on 31 March 2014 which mean that the six largest suppliers and the largest independent generators will have to trade fairly with independent suppliers in the wholesale market, or face financial penalties. The six largest suppliers will also have to publish the price at which they will trade wholesale power up to two years in advance. These prices must be published daily in two 1-hour windows, giving independent suppliers and generators the opportunity and products they need to trade and compete effectively.
235. *Offshore electricity transmission:* Ofgem worked closely with Government to design and establish a competitive, asset-based regulatory regime to secure investment in offshore transmission assets. This ensures that offshore renewable generation projects are connected to Great Britain's onshore

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<sup>100</sup> Ofgem, *Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition*, 12 June 2013.

electricity network economically and efficiently. Ofgem designed and now manages the competitive tender process for determining the Offshore Transmission Owner for a set of transmission assets.<sup>101</sup>

236. *Onshore electricity transmission:* Ofgem is actively considering various options for introducing competition for onshore electricity transmission where there are discernible benefits for consumers. The concept of a greater role for third parties in electricity transmission onshore was introduced as part of Ofgem's new RIIO framework designed to secure network investment to deliver sustainable energy at good value for consumers.<sup>102</sup> Ofgem is now taking this project forward as part of its Integrated Transmission and Planning Regulation (ITPR) project.<sup>103</sup> The development of a framework to enable competition for electricity transmission onshore will ensure that Ofgem has appropriate tools at its disposal to ensure value for consumers. Ofgem envisages that consumers could potentially benefit through reduced network charges as a result of increased innovation, lower construction costs, more timely delivery of infrastructure, and lower financing and operating costs that third parties could bring.
237. *Electricity distribution connections:* As part of the current electricity distribution price control which runs to 2015, Ofgem has introduced a new approach to facilitate competition in connections to the electricity distribution network. Distribution Network Operators (DNOs) are able to earn a regulated margin on some connection activities in market segments where Ofgem considers competition to be viable, in order to allow headroom for competition to develop. Ofgem's proposals also allow DNOs to apply for price regulation to be lifted, where they can demonstrate that effective competition exists in these market segments. This opportunity to earn an unregulated margin was designed to stimulate the removal of potential barriers to competition. Where effective competition had not developed by 31 December 2013, Ofgem is reviewing the market and will consider taking action, including by examining whether there are grounds for making a market investigation reference.
238. *Metering:* In relation to metering services, suppliers are obliged to provide smart meters to all consumers by 2020 under competitive terms. In October 2013, Ofgem published its proposed decisions in respect of the regulation of traditional gas metering. The proposed decision supports an efficient

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<sup>101</sup> See, for example: Ofgem, *Consultation on the generic Offshore Owner Licence for Tender Round 3*, 7 October 2013.

<sup>102</sup> [www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=77&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes](http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=77&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes).

<sup>103</sup> The ITPR project is a review of the Great Britain electricity transmission arrangements for system planning and delivery that currently applies onshore, offshore and for interconnection. The focus of this project is to ensure that the three separate regimes can continue to ensure the efficient, coordinated and economic development of the overall network over the longer term.

transition to smart metering and reduces the overall cost of regulated traditional gas metering by approximately £69 million.

239. *Retail gas and electricity supply:* In the retail supply market, Ofgem has been implementing a retail market reform programme designed to enable stronger consumer engagement and intensify competition in the market. Measures to reduce and simplify tariffs and tariff structures, improve consumer information and introduce new standards of conduct to ensure that suppliers treat customers fairly will serve to deliver a simpler, clearer and fairer market. These measures are coupled with reforms to improve wholesale market liquidity<sup>104</sup> and market transparency and, in turn, promote scope for more intense competition and opportunities for small providers to engage in the market.

#### *Review of regulatory measures*

240. Ofgem recognises the need to keep under review the effectiveness of direct regulatory measures following their introduction. For example, where appropriate, ‘sunset clauses’ are included in new licence conditions to enable a review of the effectiveness of direct regulatory rules. The Transmission Constraint Licence Condition<sup>105</sup> and Undue Price Discrimination Licence Condition<sup>106</sup> are two examples of this. In the case of the Transmission Constraint Licence Condition, the guidance on its application also specified that it was intended to complement competition law rather than act as a substitute.

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

241. As noted above, Ofgem’s objectives, pursuant to the EU’s Gas and Electricity Directives, include promoting a competitive, secure and environmentally sustainable internal market and effective market opening.
242. Ofgem’s competition duties under UK statutes are as described in Section 2 above.

#### ***3.2 Concurrent powers?***

243. Ofgem has powers to enforce the competition prohibitions in the Competition Act 1998 in relation to relevant gas and electricity activities (those to which the competition duties relate, as set out in Section 2 above) and to make market

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<sup>104</sup> See paragraph 234 on ‘Liquidity proposals’, above.

<sup>105</sup> Standard Condition 20 of Electricity Generation Licence.

<sup>106</sup> Standard Condition 25A of Electricity and Gas Supply Licences.

investigation references under the Enterprise Act 2002 to the CMA in relation to such activities.

### **3.3 Duty to consider competition law before taking direct regulatory action?**

244. From April 2014, Ofgem will, as a result of Schedule 14 to the ERA13, be under an obligation, before exercising its direct regulatory powers of licence enforcement in the gas and electricity sectors, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).<sup>107</sup>
245. Until now, the Gas Act section 28(5) and the Electricity Act 1989 section 25(5) have provided that 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 Competition Act. Nevertheless, as stated above, before exercising functions for the purpose of promoting competition, Ofgem has had a positive duty to consider the extent to which the interests of consumers would be protected by the promotion of competition and whether alternative ways of exercising its functions would better protect the interests of consumers, such introducing or enhancing regulatory measures. Ofgem's principal objective and general duties made clear that, while the promotion of competition is fundamental to the protection of consumers' interests, it may not always be sufficient in energy markets and in appropriate circumstances Ofgem may need to take other steps to safeguard consumers' interests.

## **4. Applying competition law in the sector**

### **4.1 Current approach**

246. In November 2012 the Government stated that its 'long-term vision for the electricity market is for a decreasing role for the Government over time, and to transition to a market where low-carbon technologies can compete fairly on price'.<sup>108</sup> Clearly a fuller understanding of the state of competition in energy markets in Great Britain, and the prospects of enhancing it, will be affected by the outcomes of the assessments by Ofgem and the competition authorities on competition and the health of the retail energy markets referred to above.

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<sup>107</sup> Gas Act 1986, section 36A, and Electricity Act 1989, section 43.

<sup>108</sup> Department of Energy and Climate Change, *Electricity market reform: policy overview*, November 2012.

## **4.2 Recent competition law cases**

### *Investigation into suppliers and trade association bodies*

247. On 28 June 2013, Ofgem closed its investigation under the competition prohibitions in the Competition Act 1998 into the behaviour of two trade association bodies and six suppliers, on the grounds of administrative priority.
248. The trade association bodies were the Energy Retail Association and the Association of Energy Suppliers. The suppliers were British Gas, EDF Energy, E.On, RWE Npower, Scottish and Southern Energy, and ScottishPower.
249. The purpose of Ofgem's investigation, which was opened in 2011, was to determine whether in the period since 1 January 2005 the parties had prevented or restricted third party intermediaries from engaging in face-to-face marketing in breach of the Chapter I prohibition on agreements restrictive of competition, including through the Code of Practice on the Face to Face Marketing of Energy Supply, more commonly known as the EnergySure Code. The Association of Energy Suppliers (a subsidiary of the Energy Retail Association) is responsible for the management of the EnergySure Code, whilst the other parties were signatories to the Code. 'Third party intermediaries' in this context refers to non-exclusive agents acting for more than one supplier, as compared to exclusive or sole agents.
250. Over the course of the investigation, Ofgem gathered information and documents using its formal powers under the Competition Act 1998 from the parties and from certain third party intermediaries which had sought to engage in face-to-face marketing. Ofgem in particular considered certain provisions of the EnergySure Code and the parties' reasons for including those provisions. Ofgem also considered the manner in which the parties had engaged with third party intermediaries seeking to engage in face-to-face marketing of energy supply.
251. On the basis of the evidence gathered by June 2013, Ofgem was not in a position to make a conclusive finding on whether or not there had been a breach of the Chapter I prohibition and considered it likely that that its resources would be better devoted to further work on the regulatory environment applicable to third party intermediaries seeking to engage in activities which include, but are not limited to, face-to-face marketing of energy supply.
252. In the light of this, Ofgem decided that it was appropriate to close the investigation on the grounds of administrative priority, taking into account the criteria set out in its Enforcement Guidelines and considering all relevant issues. In particular, Ofgem considered the likely resources required to

investigate the matter further and the availability of other actions to address the issues at hand.

253. Ofgem noted that it appeared to be more appropriate to proceed with its work on third party intermediaries, including in the context of its Retail Market Review proposals, rather than continue the investigation. At the same time as closing the investigation, a consultation on the exploration of issues and options for third party intermediaries more widely was published by Ofgem. Additionally, Ofgem noted that the EnergySure Code had, before June 2013, been amended to clarify that it does not extend to and preclude the activities of third party intermediaries.<sup>109</sup>

#### *Investigation into Electricity North West Ltd*

254. In May 2012, Ofgem accepted commitments from Electricity North West Ltd (ENW) in relation to an investigation under the competition prohibitions, specifically the Chapter II prohibition on abuse of a dominant position.
255. An independent distribution system operator had complained that the charges levied on it by ENW for connection into its distribution service area gave it no opportunity to earn any margin and as such amounted to a vertical margin squeeze by a dominant company. An investigation was opened and Ofgem identified a number of competition concerns. Some of these were addressed by industry developments and actions taken by ENW; Ofgem considered that the remaining competition concerns about this case were fully addressed by the commitments offered by ENW. Formal acceptance of the commitments by Ofgem resulted in the termination of the investigation without the need for any decision on whether or not competition law had been infringed.

#### *Retail energy review 2013/14*

256. In a significant example of joint working between competition authorities and sectoral regulators, Ofgem is – as mentioned in Section 1 above – currently working with the OFT/CMA to produce an assessment of competition in energy markets. The framework for the assessment was published in December 2013, and the first assessment was published on 27 March 2014.

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<sup>109</sup> The consultation on issues and options for third party intermediaries closed in August 2013. In October 2013, Ofgem issued an open letter setting out its proposed next steps relating to third party intermediaries (TPIs). These include considering the outputs from research, responses to the June 2013 consultation and stakeholder engagement to help inform development of a strategy for the enduring regulatory framework for TPIs. The open letter noted more immediate issues in this sector and the development of potential regulatory measures to address these issues, including, but not limited to, Collective Switching, a review of the Confidence Code and a Code of Practice for non-domestic TPIs. In January 2014, a consultation on collective switching was launched. In February 2014, a consultation on the potential regulatory options for the non-domestic TPI market was published. For all documents relating to the TPI programme, see [www.ofgem.gov.uk/publications-and-updates/open-letter-third-party-intermediaries-tpi-programme](http://www.ofgem.gov.uk/publications-and-updates/open-letter-third-party-intermediaries-tpi-programme).

### 4.3 Competition law data 2005 to 2013

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2005-2013	
<b>Number of complaints</b> <sup>110</sup>	10
<b>Number of investigations formally launched</b>	5
<b>Number of those cases in which:</b>	
- information gathering powers were used	5
- powers to enter premises/conduct dawn raids were used	0
- a Statement of Objections was issued	1
<b>Number of those cases that resulted in:</b>	
- an infringement decision	1
- the giving of commitments or undertakings to change conduct	1
- an exemption or clearance decision (or equivalent)	0
- case closure without full resolution	3
<b>Number of cases that are ongoing</b>	0
<b>Number of cases in which the decision was appealed to the CAT</b>	1

Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2005–2013	
<b>Number of market studies</b> <sup>111</sup>	
Initiated	3
<b>Number of studies/reviews that resulted in</b>	
- the giving of undertakings	0
- a market investigation reference to the Competition Commission	0

## 5. Looking ahead

257. Issues in relation to the energy sector that will be a focus of consideration in the year ahead and beyond will of course be affected by the assessment of competition in energy markets which it has been conducting jointly with the OFT and CMA. In addition:

- Ofgem will continue with its programme of putting in place the reforms coming out of its Retail Markets Review (see Section 2.1, above).
- Ofgem will also complete implementation of the proposed reforms to enhance liquidity in the forward wholesale electricity market, which are designed to deliver opportunities to trade to permit independent generators and suppliers to compete effectively, to encourage competition between

<sup>110</sup> Note: ‘Complaints’ under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions and which are ‘specific, well-reasoned, clear and supported by all available relevant evidence’ as required by Ofgem’s *Enforcement Guidelines on Complaints and Investigations*.

<sup>111</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

the major energy suppliers and to increase transparency of wholesale energy prices.

- Alongside this, Ofgem will continue its work around the activities of third party intermediaries (TPIs) in the market (see Section 4.2 above) and will also seek to maximise the opportunities to develop competition arising from the roll-out of smart meters.

Separately from the retail and wholesale side, Ofgem will follow its review of competition in electricity distribution connections by reviewing those parts of the market where it has not seen effective competition and consider whether the electricity distribution networks have removed barriers to entry as required and consider whether – and, if so, what – further action is necessary.

## **F. Financial services – Financial Conduct Authority/ Payment Systems Regulator**

### **1. General market conditions**

258. In the aftermath of the financial crisis of 2007/08, there was emphasis on the need for increasing direct regulatory intervention to protect consumers (both private and corporate) and the financial system itself. Initially there was little focus on competition in financial services (and, indeed, in 2008 the Government overrode OFT concerns about the effects on competition of the Lloyds TSB acquisition of HBOS, legislating to allow the merger to proceed in the interests of the stability of the UK financial system<sup>112</sup>).
259. More recently, however, concerns have been expressed about the extent of competition in financial services, and the need to promote competition in the interests of consumers and the efficiency and effectiveness of the system, including in particular in retail banking. The financial services regulator – the new Financial Conduct Authority (FCA), replacing the Financial Services Authority – was given for the first time a duty and an objective to promote competition, with effect from April 2013, and from April 2015 will have powers to apply the competition prohibitions concurrently with the CMA. Even before April 2015, in a significant example of joint working between competition authorities and sectoral regulators, the OFT in late 2013 and early 2014 conducted a market study into retail banking for SMEs, working closely with the FCA.
260. A significant concern for the effectiveness of competition in financial services is lack of consumer engagement. Without engaged consumers, even firms that are focused on customer service and good value products cannot win significant market share from incumbents. This potentially creates a vicious circle where lack of consumer engagement makes other competition problems worse, for example where consumer inertia raises existing barriers to entry.
261. Another concern is that with many financial products it is difficult to gain experience – for example, people might not realise that they have a bad deal on their pension until 30 years later. The same can be true for insurance contracts. Most people do not read all the small print, which means that a customer might only find out about a particular exclusion when making a claim.

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<sup>112</sup> A useful summary of these developments was published by the House of Commons Library, Standard Note SN/BT/4907, *The Lloyds-TSB and HBOS merger: competition issues*, 15 December 2008.

262. There can also be significant informational asymmetries between providers and consumers of financial products. As experience has shown, even supposedly sophisticated consumers can have a poor understanding of the financial products they are buying. The reality is also that many firms add layers of complexity – technical jargon, lengthy terms and conditions, and buying decisions with drip pricing.
263. The Independent Commission on Banking, chaired by Sir John Vickers, referred to such information asymmetries in its ‘issues paper’ of 2010 which said that possible distortions of incentives in financial services markets include: ‘ill-informed choice by customers – leading to their being exploited’.<sup>113</sup>
264. In addition to these problems is the recent backdrop of the financial crisis, during which concentration increased in several financial services markets – particularly in retail banking, which was already significantly concentrated by most measures. The landscape is still changing and the FCA will monitor the developments carefully. The introduction of the Current Account Switching Service in September 2013 could help improve switching rates for current account holders. The divestments of parts of RBS and Lloyds (in pursuance of the requirements of the EU’s state aid rules) could also change the way competition works in core banking markets; the likely effects on competition of these divestments were set out in a letter from the OFT to the Chancellor of the Exchequer in September 2013.<sup>114</sup>

## **2. The direct regulation regime in the sector**

265. The FCA inherited responsibility for conduct regulation in financial services following the split of the Financial Services Authority into the FCA and Prudential Regulation Authority (PRA) in April 2013, becoming the conduct and compliance supervisor for around 26,000 firms across the whole industry, as well as the prudential supervisor for around 23,000 firms not regulated by the PRA. As of 1 April 2014, the FCA is in addition responsible for the regulation of around 50,000 consumer credit firms, having taken over this function from the OFT.

## **3. The competition law regime in the sector**

### ***3.1 Duty to promote competition?***

266. One of the changes accompanying the establishment of the FCA has been the introduction of a statutory objective to promote effective competition in the

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<sup>113</sup> Independent Commission on Banking, *Issues Paper – call for evidence*, September 2010, paragraph 3.9.

<sup>114</sup> Letter from Clive Maxwell, Chief Executive of the OFT, to George Osborne, Chancellor of the Exchequer, 11 September 2013.

interests of consumers.<sup>115</sup> This, combined with a duty to promote competition when discharging general functions,<sup>116</sup> gives the FCA a powerful new mandate to consider how to make competition more effective in the markets it regulates, regardless of the specific objective the FCA is pursuing.

### **3.2 Concurrent powers?**

267. Despite receiving a new competition mandate, the FCA was not granted concurrent powers in the Financial Services Act 2012. This means that, unlike other sectoral regulators referred to in this report, the FCA does not yet have the power to enforce the Competition Act 1998 or make market investigation references under the Enterprise Act 2002. However, the FCA can use all of its regulatory powers in pursuit of its competition objective.
268. The high priority which the organisation has given to its new role in promoting competition is an important factor in the decision to include the FCA in this report.
269. The Financial Services (Banking Reform) Act 2013 grants the FCA concurrent powers from April 2015, to enforce the competition prohibitions in the Competition Act 1998 and to make market investigation references under the Enterprise Act 2002 to the CMA in relation to the provision of financial services.<sup>117</sup>
270. The new Payment Systems Regulator, being incorporated by the FCA in April 2014, and fully operational in April 2015, will also have the full set of concurrent powers from April 2015.<sup>118</sup> In the 2014 Budget, the Government announced that the Payment Systems Regulator will acquire the concurrent power to make market investigation references a year ahead of this, ie from April 2014.
271. At this point the FCA's remit will become more aligned with the other sectoral regulators in this report and this will be reflected in future versions of the

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<sup>115</sup> This sits alongside the FCA's other two operational objectives:  
(a) to secure an appropriate degree of protection for consumers; and  
(b) to protect and enhance the integrity of the UK financial system.

Together, these three operational objectives support the FCA's strategic objective – to ensure that the relevant markets function well.

<sup>116</sup> The FCA's general functions are:

- (a) its function of making rules under the Financial Services and Markets Act 2000 (as amended);
- (b) its function of preparing and issuing codes under that Act;
- (c) its functions in relation to the giving of general guidance under that Act; and
- (d) its function of determining the general policy and principles by reference to which it performs particular functions under that Act.

<sup>117</sup> Financial Services (Banking Reform) Act 2013, Schedule 8, Part 1.

<sup>118</sup> Financial Services (Banking Reform) Act 2013, sections 59–61.

CMA's annual concurrency report. This year's report will focus on the competition work that the FCA is carrying out under its existing mandate.

### **3.3 *Duty to consider competition law before taking direct regulatory action?***

272. From April 2015, both the FCA and the new Payment Systems Regulator will be under an obligation, before exercising certain of their direct regulatory powers, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).<sup>119</sup>

## **4. Promoting competition in the financial services sector**

### **4.1 *Current approach***

273. The FCA sees effective competition as complementary to its other operational objectives. However, some stakeholders have raised concerns that competition might run counter to the FCA's consumer protection objective – for example, that if the FCA encourages more firms to compete in a market, this could increase the risk of mis-selling to consumers. The FCA's view is that such conflict is very unlikely to be the case – the FCA's whole approach to promoting competition is shaped by the likely impact on consumers (meaning both individuals and business customers).

274. The FCA is not interested in promoting competition for its own sake, but rather for the benefits the FCA thinks will flow from competition. Such benefits include lower prices, genuine choice, quality products and services, and useful innovation. Similarly, the systemic importance of financial services means that the FCA would not regard competition as being in the interests of consumers if it were to lead to significant disruption and reduced integrity of the financial system.

275. The FCA's goal, therefore, will be effectively competitive financial services markets in which firms put their customers at the heart of everything they do and offer them good value products and services.

276. Market studies are an important tool, and the FCA will use market studies as part of its new competition approach. Market studies will be used to analyse the effectiveness of competition in markets that the FCA regulates, analysing the markets from all angles, to understand the interactions between both demand- and supply-side competition weaknesses. If the FCA concludes that competition is not working well in a market and therefore needs to take action, it can intervene to promote effective competition using its regulatory powers, for example through rule-making, guidance, or firm-specific enforcement. The

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<sup>119</sup> Financial Services (Banking Reform) Act 2013, Schedule 8, Part 1, and section 62.

FCA can also ask another authority such as the OFT (and in future the CMA) to look into a market.

277. Each market study will involve gathering specific information from a broad set of stakeholders including firms, intermediaries, trade bodies, consumers, and consumer bodies. The FCA will spend considerable time ‘upfront’ engaging with firms before sending them information requests. As a result, firms should find it easier to respond to FCA requests and the FCA will get better quality information. This aligns with the FCA’s recently published data strategy.<sup>120</sup> The FCA has also built close relationships with consumer groups and this, together with its own research, will help the FCA to obtain the insights it needs to understand the consumer experience. Some of these consumer groups will have the ability to lodge super-complaints with the FCA, which could be another way the FCA obtains insights into the competitiveness of financial services markets.
278. An essential part of the FCA’s work so far has been building a team with the right skills and experience to deliver its competition mandate. The FCA has recruited experienced competition lawyers and economists and recruitment will continue, particularly in preparation for gaining concurrent powers from April 2015. The FCA has also been ‘up-skilling’ existing staff. It has rolled out introductory competition training to all FCA staff as well as more advanced training to priority areas, such as its policy makers.

#### **4.2 Recent competition studies**

279. In September 2013, the FCA announced its programme of work into competition for the year ahead, focusing on markets where it thinks ineffective competition might be leading to poor outcomes for consumers.<sup>121</sup> This included a market study into cash savings and a possible market study into retirement income. The FCA already had an ongoing study into general insurance add-on markets<sup>122</sup> which it concluded in March 2014.
280. In October 2013, the FCA launched a market study into cash savings.<sup>123</sup> This study is focusing on interest-bearing cash savings accounts that enable consumers to store their cash and generate an interest rate return, but typically offer limited transaction functions (eg compared to current accounts) and is examining the nature of competition in the market, and obstacles to consumers switching their savings between accounts, including:

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<sup>120</sup> [www.fca.org.uk/static/documents/corporate/fca-data-strategy.pdf](http://www.fca.org.uk/static/documents/corporate/fca-data-strategy.pdf).

<sup>121</sup> Christopher Woolard (Director of Policy, Risk and Research at the FCA), speech at Regulatory Policy Institute annual competition and regulation conference, 9 September 2013.

<sup>122</sup> [www.fca.org.uk/static/documents/general-insurance-add-on-market-study.pdf](http://www.fca.org.uk/static/documents/general-insurance-add-on-market-study.pdf).

<sup>123</sup> [www.fca.org.uk/news/market-studies/cash-savings-market-study](http://www.fca.org.uk/news/market-studies/cash-savings-market-study).

- supplier behaviour, such as number and variety of accounts offered, terms and conditions, interest rates offered (including bonus rates), distribution channels, and information provided
  - consumer behaviour, including switching behaviour and consumers' understanding of product features
281. An interim report on this study will be published in summer 2014 and a final report in October 2014.
282. Subsequently the FCA launched a market study into retirement income<sup>124</sup> which followed on from publication of the findings of a thematic review of annuities undertaken by the FCA.<sup>125</sup> This study is focusing on the options for retirement income that can be purchased from a pension pot (ie annuities and income drawdown). The FCA is examining whether there are obstacles to competition working more effectively for consumers in this market, including the behaviour of consumers (eg consumer inertia), the conduct of firms (eg sales practices) and the structural features of the market (eg distribution and the impact of advised/non-advised sales, and possible regulatory barriers). The FCA expects to publish an interim report in the summer and the final report within 12 months from launch.
283. The FCA will also be paying close attention to upstream markets, which the FCA typically refers to as wholesale markets. In financial services more than elsewhere, these can involve complicated conflicts of interest and perverse incentives. These features may give rise to competition issues and the FCA will be assessing the risk of significant consumer detriment. Experience from other parts of the economy shows that actions to improve competition in wholesale markets can often have very considerable benefits to consumers, at both the wholesale and the retail level. In 2014, the FCA will make an initial assessment of competition issues in wholesale markets as part of a competition review of the wholesale sector, with a view to identifying potential candidates for market studies. It will then take action as required, which includes the possibility of close working with other competition authorities.
284. In all its competition work, the FCA recognises the importance of effective coordination with other authorities. There are two significant examples already. First, the FCA has been collaborating with the OFT in relation to the work on SME banking. The FCA has some of its staff embedded in the OFT team and sees this as a possible model for future cooperation between the FCA and other competition authorities. In its market study into add-on general

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<sup>124</sup> [www.fca.org.uk/news/market-studies/retirement-income-market-study](http://www.fca.org.uk/news/market-studies/retirement-income-market-study).

<sup>125</sup> [www.fca.org.uk/news/tr14-02-thematic-review-of-annuities](http://www.fca.org.uk/news/tr14-02-thematic-review-of-annuities).

insurance, the FCA ensured that its work was joined up with the Competition Commission's market investigation into private motor insurance.

285. Second, the Competition Commission and the FCA have liaised closely and effectively since the launch in June 2013 of the current market investigation into payday lending reference. The Chair of the Competition Commission Inquiry Group met the Chief Executive of the FCA in December 2013, and the FCA attended a hearing with the Competition Commission in March 2014. Staff from both organisations have met approximately every six to eight weeks since the reference with regular telephone contact in between. This work has involved sharing high-level outlines of the work being undertaken by both organisations, timings and risks; and, following a formal request from the FCA to inform its work on a price cap, the sharing of data collected by the Competition Commission as part of its market investigation. All contact between the two organisations has been recorded, with both organisations mindful of their separate statutory remits.
286. The FCA intends to carry over these cooperative principles to its relationship with the CMA – not only to avoid duplication, but to ensure that the two authorities share best practice and expertise wherever possible.
287. As well as the external facing work, there has also been important progress behind the scenes. Historically, financial regulators have been focused mainly on the stability of systems and consumer protection. The FCA is building on foundations laid by regulatory bodies that had no explicit competition mandate. So it has started taking a critical look at its own regime – for example, streamlining its authorisation process for new banks and reviewing its Handbook of rules.

#### **4.3 Competition law data 2005 to 2013**

288. The FCA will not have concurrent competition law powers until April 2015 but, as described in Section 4.2, has conducted market studies in connection with its competition objective under its existing sector-specific powers.

### **5. Looking ahead**

289. Issues in relation to financial services that will be a focus of consideration in the year ahead and beyond include the following.
290. In the year ahead, the FCA is committed to continuing to deliver on its mandate to promote effective competition in the interests of consumers.
291. The FCA will continue to embed promotion of effective competition into its regulatory approach. This will include delivering more competition training to

the organisation, ensuring a joined-up approach between its market studies work and its thematic work, and assessing the competition implications of all policy proposals.

292. The FCA will be gearing up in preparation of receiving concurrent powers from April 2015. This will require internal preparation in terms of recruiting staff and developing its processes. It will also involve an external consultation in the autumn on the FCA's proposed procedures for exercising its concurrent powers.
293. The FCA will be establishing the new regulator of payment systems. It will ensure that the Payment Systems Regulator has the right staff and support ahead of becoming fully operational from April 2015. One of the new regulator's objectives will be to promote competition. It will also have concurrent powers with respect to payment systems.
294. The FCA will be finalising its findings and working on remedies following its market study into general insurance add-ons. Its report on this, published in March 2014,<sup>126</sup> set out a number of proposed remedies that the FCA believes will strengthen competition in the markets for add-ons by improving the way decisions are presented to consumers and the way add-ons are sold, and by putting pressure on firms to improve product value across both add-on and stand-alone products.
295. The FCA will undertake a review of competition issues in wholesale markets, identifying potential candidates for market studies and taking action as required.
296. The FCA will progress and complete the market studies which are already in train. Specifically:
  - It will publish the final report from its cash savings market study in October 2014. It will announce its interim findings early in the summer.
  - It will publish the final report from its retirement income market study in early 2015. It will announce its interim findings in the summer.
297. From April 2014, the FCA takes over regulation of consumer credit from the OFT. Therefore, in the year ahead the FCA will consider whether there are competition issues in this new area of responsibility and what action, if any, we might need to take.

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<sup>126</sup> [www.fca.org.uk/your-fca/documents/market-studies/ms14-01](http://www.fca.org.uk/your-fca/documents/market-studies/ms14-01).

## **G. Health care services in England – Monitor**

298. Monitor is the sector regulator for health services in England. This role was established by the Health and Social Care Act 2012 and Monitor assumed its functions as the sector regulator in April 2013.
299. Monitor has a range of statutory duties. Its job is to protect and promote the interests of patients by ensuring that the whole sector works for their benefit. Monitor seeks to ensure that:
- public sector providers are well led so that they can provide high-quality care to local communities
  - essential NHS services continue if a provider gets into difficulty
  - the NHS payment system rewards quality and efficiency
  - choice and competition operate in the best interests of patients
300. Since April 2013 Monitor has had concurrent powers with the CMA to enforce competition law in respect of the provision of health care services in England under the Competition Act 1998 and the Enterprise Act 2002. It also has other powers to enable it to protect choice and prevent anticompetitive behaviour. However, unlike other sectoral regulators, Monitor does not have a duty to promote competition.

### **1. General market conditions**

#### ***Overview of competition in the NHS in England***

301. Competition in NHS health care in England operates differently from other regulated sectors – there are rules that apply to the behaviour of *commissioners* (purchasers of care, such as Clinical Commissioning Groups, which include GP practices) as well as health care *providers* (suppliers of care, such as hospitals).
302. Government policy is that providers should compete on the basis of the quality of their care, not the price. This is because it is important to patients that the care they receive is of high quality, and that decisions about the treatment they need are based on clinical requirements, not cost. In general, commissioners act on behalf of patients to secure local health services. Their objective is to secure the best-quality, value-for-money, services, partly by using competition.

## **Context**

303. The NHS in England, responsible for the overwhelming majority of health care services in England (including at both GP and hospital level), is a much cherished institution. Its structure has traditionally been one in which markets and competition have tended to be subordinate to other imperatives. It provides patients with GP and hospital care (as well as other services) free of charge, and it achieves this through state funding from central government. The NHS is essentially owned and operated by the state.
304. Although there are also private health care services, these represent only a small proportion of health care, and in recent Competition Commission reports privately-funded health care services were treated as constituting a separate market from the provision of NHS services.<sup>127</sup>
305. Moreover, the concept of competition in the NHS generates political controversy, illustrated in recent years, for example, by the debate over the reform proposals that led to the Health and Social Care Act 2012.

## **Development of competition in recent years**

306. Nevertheless, and despite these constraints, moves have been made in recent years, by governments of various political complexions, to introduce some competition within the framework of the NHS, without compromising the principle of health care provision being free of charge to patients at the point of use. Monitor has told us that choice and competition have existed within the NHS for many years and are now governed by specific rules laid down by Parliament, in particular the Health and Social Care Act 2012, and the Procurement, Patient Choice and Competition Regulations 2013. These rules largely reproduce the rules in place prior to the 2012 Act.
307. As recently described by the Competition Commission,<sup>128</sup> government initiatives relating to the introduction of competition and choice in the provision of NHS services date back a number of decades. There has been an evolution from a centrally-organised NHS to a situation in which providers (eg hospitals) and commissioners (eg GPs procuring services from hospitals on behalf of their patients) have increasing levels of autonomy which can be harnessed to ensure that competition will be a meaningful driver of quality.

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<sup>127</sup> Competition Commission, *The Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust/Poole Hospital NHS Foundation Trust – a report on the anticipated merger*, 17 October 2013, paragraph 5.51. See also Competition Commission, *Private health market investigation – provisional findings report*, 2 September 2013, paragraph 5.52(a).

<sup>128</sup> Competition Commission, *The Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust/Poole Hospital NHS Foundation Trust – a report on the anticipated merger*, 17 October 2013, Appendix C, paragraph 45, read with paragraphs 2 and 4.

Preparatory steps to facilitate the introduction of more effective competition have included:

- From 1991, splitting the responsibility for providing healthcare from the responsibility for purchasing it (referred to as the purchaser/provider split).
- From 2003, the establishment of NHS foundation trusts to operate hospitals (into which more traditional NHS trusts could convert subject to meeting the criteria). These are public benefit corporations which are required to provide certain NHS services but are also afforded a degree of operational autonomy, including the right to retain their surpluses and borrow to invest in new and improved services for patients and service users, giving them an incentive to maximise their income by taking steps to attract patients for profitable specialties, for example by maintaining and improving service quality.
- From around 2003, the introduction of PbR (payment by results), namely the payment of fixed national tariff prices per treatment to NHS acute service providers according to the volume of patient treatments provided. PbR tariffs replaced block contracts that remunerated providers irrespective of the number of patients treated – see Section 2.1 below.
- From 2004, the introduction and gradual extension of patient choice and mechanisms to facilitate the exercise of patient choice, such as the ‘Choose and Book’ website and the NHS Choices website. In 2009, patients’ ability to choose the provider for a first consultant-led outpatient appointment in relation to elective care was also set out in the NHS Constitution.
- From around 2007, the establishment of the Any Qualified Provider model, allowing qualified providers to have a contract with an NHS commissioner to provide certain NHS services. In 2009, patients’ ability to choose the provider for a first consultant-led outpatient appointment in relation to elective care was also set out in the NHS Constitution.
- From 2004, the provision by independent sector treatment centres of some NHS services.
- The application of procurement rules to commissioners (eg GP practices); these rules have applied in the past to the extent that commissioners were ‘public contracting entities’ for the purposes of European procurement rules such as the 2006 Public Contracts Regulations 2006. The Health and Social Care Act 2012 included provisions regarding the manner in which clinical commissioning groups (typically consisting of GP practices) and

NHS England procure services. This type of procurement is most relevant when considering competition ‘for’ the market for NHS services.

### ***How competition works***

308. The cumulative effect of these measures has been the development of essentially two modes of competition in the provision of health care services in England:
- (a) competition ‘in’ the market – where patients, referred by their GPs, have a choice between providers of a service – typically in respect of routine ‘elective’ services (ie planned services and maternity services; payments are generally on the basis of nationally-determined PbR tariffs); and
  - (b) competition ‘for’ the market where the commissioning entity (eg GP practice or practices) uses a competitive process to choose between different providers (eg hospitals) to award contracts for the right to provide certain services to patients.<sup>129</sup>
309. The result is that, although there is only very limited competition on price (with most prices conforming to nationally-set tariffs – see Section 2 below), there is, increasingly, a degree of meaningful competition on quality, although it is in its relative infancy and still developing:
- (a) On the demand side, there are real motivators for choosing between competing providers. Patients clearly want (where there are a number of hospital providers of comparable services within reasonable proximity) to receive the best quality service – eg as regards waiting times, care and attentiveness, and success rates in dealing with particular conditions – and will be influenced by their own experiences, anecdotal evidence and recommendations from people they know, and published data, as well from their GPs’ recommendations. The GPs, for their part, have incentives to choose (or recommend) good hospitals to their patients, given that their own reputations among patients depend in part on the success of referrals, and their income is affected by the number of patients who choose to be registered with a particular GP or GP practice. (There is some evidence that patients and their GPs are increasingly aware of the choices available to them, and that they increasingly value such choice.<sup>130</sup>)
  - (b) On the supply side, a study by the Centre for Market and Public Organisation (dated 2010/11) has described the incentives, which flow

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<sup>129</sup> Competition Commission (as above), Appendix C, paragraph 46.

<sup>130</sup> Competition Commission (as above), Appendix H, paragraphs 23–27.

from payments going to hospital trusts in respect of the patients they treat on a PbR tariff, as follows:

NHS hospitals have incentives to respond to increased competition. While NHS hospitals are public organizations, the regime they operate under gives hospital managers strong incentives not to make losses. The government monitors the performance of hospitals on an annual basis and publishes summary assessments of their performance based on a range of indicators. These include measures of quality of care, access to care and financial performance. The weight given to financial performance in the summary assessments is high. Managers of hospitals which perform poorly in terms of the summary assessments may be replaced (and this does happen), while hospitals which perform well can get the greater autonomy awarded to Foundation Trust status. Further, hospitals with FT status can retain surpluses, and non-FT hospitals that perform well have the opportunity to earn FT status.<sup>131</sup>

Monitor, in evidence submitted to the Competition Commission in the context of an NHS hospital merger inquiry, described the supply-side incentives as follows:

Hospital trusts therefore have an incentive to compete with other providers of NHS-funded hospital services to attract patient referrals and win contracts. The Competition Commission<sup>132</sup> has observed hospital trusts competing to be the provider of choice for each of the following groups: patients, general practitioners, consultants, and commissioners. The Competition Commission has observed that hospitals' main response to competitive pressure has been investing to deliver quality improvements and communicating this to patients, general practitioners, consultants, and commissioners.<sup>133</sup>

The Competition Commission in that case accepted that there are significant incentives to compete, particularly in the case of foundation trusts (which were

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<sup>131</sup> Martin Gaynor, Rodrigo Moreno-Serra and Carl Propper, *Death by Market Power: Reform, competition and patient outcomes in the National Health Service*, Centre for Market and Public Organisation Working paper no. 10/242, pages 10–11.

<sup>132</sup> The Co-operation and Competition Panel, previously an advisory body to the Department of Health and to Monitor and, since April 2013, part of Monitor.

<sup>133</sup> Monitor, Submission to the Competition Commission on The Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust/Poole Hospital NHS Foundation Trust merger inquiry, paragraph 6.

the subject of the case).<sup>134</sup> The Competition Commission also found evidence of the hospitals concerned engaging in marketing and promotional activities to succeed competitively and attract new market share.<sup>135</sup>

310. Moreover a body of research in recent years, since the Labour Government's introduction of increased competition in 2006 and 2008, seems to suggest that, even where there is no or limited price competition, competition on quality can in fact lead to improvements in hospital service standards.<sup>136</sup>
311. In addition, under the Health and Social Care Act 2012, procedures introduced in 2008 to combat anticompetitive activity have been put on a statutory footing (as described in Section 3 below).

## **2. The direct regulation regime in the sector**

312. In April 2013, under the Health and Social Care Act 2012, Monitor was established as the sector regulator for health (Monitor had originally been established in 2004, but only with responsibility for responsible for authorising, monitoring and regulating NHS foundation trusts). As sector regulator, Monitor's main duty is now to protect and promote the interests of people who use health care services by promoting provision of healthcare services which is economic, efficient and effective, and maintains or improves the quality of the services.
313. Monitor's role involves managing key aspects of health care regulation, including: regulating prices; enabling services to be provided in an integrated way; safeguarding choice and competition; and supporting commissioners so that they can ensure essential health services continue to run if a provider gets into financial difficulties. Monitor will also continue to ensure that the boards of foundation trusts focus on good leadership and governance, and Monitor will have a continuing role in assessing the remaining NHS trusts when they apply for foundation trust status.<sup>137</sup>
314. Additionally, it is important to establish minimum quality requirements for health care providers to ensure that they are safe and effective. It is the job of the Care Quality Commission to assess the quality of healthcare providers.

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<sup>134</sup> Competition Commission, *The Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust/Poole Hospital NHS Foundation Trust – a report on the anticipated merger*, 17 October 2013, paragraphs 2.31–2.37, and Appendix C, paragraphs 54–74.

<sup>135</sup> Competition Commission (as above), Appendix H, paragraphs 63–89.

<sup>136</sup> Competition Commission (as above), paragraph 6.78, and Appendix H, paragraphs 22–50.

<sup>137</sup> Monitor, Submission to the Competition Commission on The Royal Bournemouth and Christchurch Hospitals NHS Foundation Trust/Poole Hospital NHS Foundation Trust merger inquiry, paragraphs 7 and 8.

## **2.1 Using direct regulation to enable competition**

315. Direct ('ex ante') regulation relating to competition takes the form of policy instruments relating to healthcare financing. In particular, competition on quality is enabled by the pricing arrangements referred to above: a national tariff of prices for healthcare and a system of funding called payment by results (PbR).
316. The national tariff, which Monitor became responsible for producing in 2013, sets prices for a range of NHS treatments. These prices reflect the cost of providing a treatment in a high-quality and efficient way. This creates an incentive for providers to improve efficiency and quality so that they can provide services at or below the tariff price while attracting patients to use the service.
317. Under PbR, hospitals and other providers are paid for the activity they undertake. This incentivises providers to compete to attract patients because they receive the tariff price for each treatment they provide.
318. From 2014, all providers of NHS care (with some exceptions) will be licensed to do so by Monitor. Licensed providers will be permitted to provide NHS funded care, some of which will be delivered through PbR and the national tariff, enabling quality-based competition in the sector.

## **3. The competition law regime in the sector**

### **3.1 Duty to promote competition?**

319. Monitor's duties relating to competition exist in the context of its overall duty to patients.
320. The Health and Social Care Act 2012 does not impose on Monitor a duty to promote competition, but it does create a general duty that:

Monitor must exercise its functions with a view to preventing anti-competitive behaviour in the provision of health care services for the purposes of the NHS which is against the interests of people who use such services.<sup>138</sup>

This duty is relevant to Monitor's concurrent competition law powers (described in Section 3.2 below).

321. Monitor has a number of powers to enable us to protect choice and prevent anticompetitive behaviour. In addition to its concurrent powers to enforce the

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<sup>138</sup> Health and Social Care Act 2012, section 62(3).

competition prohibitions in the Competition Act 1998 and to make market investigation references under the Enterprise Act 2002 (described in Section 3.2 below), Monitor can:

- apply and enforce sections of the provider licence related to integrated care and choice and competition
- apply and enforce the Procurement, Patient Choice and Competition Regulations and relevant sections of the Responsibilities and Standing Rules

322. Monitor has a Choice and Competition Directorate which is responsible for exercising its powers relating to choice and competition. This contributes to Monitor's overall objective which is to make the health sector work better for patients.

### **3.2 Concurrent powers?**

323. The Health and Social Care Act 2012 also conferred on Monitor, with effect from April 2013, concurrent competition powers to enforce the competition prohibitions in the Competition Act 1998 in relation to the provision of health care services in England, and to make market investigation references under the Enterprise Act 2002 to the CMA in relation to the provision of such services.<sup>139</sup>

324. Before this, the NHS was, from April 2008 onwards, subject to an explicit set of 'Principles and Rules for Co-operation and Competition', and related guidelines based on the competition prohibitions in the Competition Act 1998. Ensuring compliance with these was entrusted to the Co-operation and Competition Panel (CCP), which was an advisory body to the Department of Health and to Monitor (but which, since April 2013, is part of Monitor).

### **3.3 Duty to consider competition law before taking direct regulatory action?**

325. From April 2014, Monitor will, as a result of Schedule 14 to the ERR13, be under an obligation, before exercising certain of its direct regulatory powers, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).

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<sup>139</sup> Health and Social Care Act 2012, sections 72 and 73.

## 4. Applying competition law in the sector

### 4.1 Current approach

326. Monitor summarised its position in a document which it published in August 2013, shortly after being entrusted with competition powers:

Choice and competition have existed within the NHS for many years and are now governed by specific rules laid down by Parliament, such as the Competition Act 1998 and the Procurement, Choice and Competition Regulations 2013. It is up to commissioners to decide if, and when, to use competition. However, we police the rules and make sure that choice and competition operate in the best interests of patients. In particular, we act to prevent anti-competitive behaviour by commissioners or providers where it is against patients' interests.<sup>140</sup>

327. Separately, in October 2013, in the context of the application of competition law to mergers between NHS hospitals (using the UK merger control rules in the Enterprise Act 2002), Monitor, the OFT and the Competition Commission have issued a joint statement on applying the regime.<sup>141</sup>
328. Because the statutory rules about competition in healthcare are relatively new, there has been little discussion between Monitor and stakeholders about relying more on competition law. In particular, competition law does not apply to the commissioners of care, who are governed by sector-specific rules about preventing anticompetitive behaviour that is not in the interests of patients. Monitor's view is that the rules around competition in the NHS as they stand enable the system to deliver good outcomes for patients.

### 4.2 Recent competition law cases

329. Monitor assumed its new functions, including its concurrent competition law powers, in April 2013. Since then it has offered informal advice and guidance to stakeholders about how to interpret and apply the rules about competition.
330. There are also several ongoing formal investigations that were commenced after April 2013, details of which can be found on the Monitor website. However, none of these has thus far been based on explicit competition law powers.

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<sup>140</sup> Monitor, *About Monitor: an introduction to our role*, 28 August 2013, page 7.

<sup>141</sup> Joint statement from the OFT, the Competition Commission and Monitor, *Ensuring that patients' interests are at the heart of assessing hospital mergers*, 17 October 2013.

331. Investigations conducted under the pre-April 2013 regime include the following.

*South Staffordshire and Shropshire NHS Foundation Trust conduct complaint – 2010–12*

332. This case involved the CCP applying the guidelines based on the competition prohibitions in the Competition Act 1998, before the CCP's incorporation into Monitor.

333. During 2010 South Staffordshire Primary Care Trust decided to hold a tender for diagnostic services for children aged 18 or below suspected of having Autistic Spectrum Disorder (ASD) and intervention services, specific to ASD, for children aged 18 or below diagnosed with an ASD. Midlands Psychology won the tender to provide the ASD services for a period of three years commencing on 1 October 2010. Ahead of the tender, these services had been provided by South Staffordshire and Shropshire NHS Foundation Trust.

334. Midlands Psychology alleged that South Staffordshire and Shropshire NHS Foundation Trust's conduct following the award of a contract had made it more difficult for Midlands Psychology to provide services to patients under the contract by either not providing or taking too much time to provide relevant data in relation to staff and patient records; making some clinically inappropriate referrals to Midlands Psychology that resulted in a significantly higher referral rate than had been expected, and by not facilitating the provision of an NHS net address required for the sharing of confidential patient information.

335. In deciding to investigate these claims in further detail, the CCP noted its concern that the effect of such conduct could be a restriction of choice or competition in the supply of ASD services in the future if it meant that Midlands Psychology was unable to provide the service required, that Midlands Psychology was not considered a credible bidder when the service was next tendered, or that other potential competitors were deterred in the future.

336. In June 2012, the CCP decided to take no further action as Midlands Psychology and South Staffordshire and Shropshire Healthcare NHS Foundation Trust had entered into discussions, led by South Staffordshire PCT, that had resulted in a resolution of the issues that had been raised.

*Study of restrictions on consultants in relation to NHS work during non-contracted hours*

337. In April 2009, the Department of Health and Monitor asked the CCP to carry out a study of restrictions placed on consultants in relation to the non-

contracted hours that they can work for other providers of NHS-funded healthcare services. The study identified a number of restrictions being placed by individual Trusts on consultants' work for other providers of NHS-funded services during their non-contracted hours. The CCP concluded that patients and taxpayers only benefit from restrictions on consultants' use of their non-contracted hours that inhibit their ability to work for other providers of NHS-funded services where these restrictions relate to: patient safety; and/or unmanageable conflicts of interest.

338. The CCP recommended that the only restrictions that should be imposed by Trusts on consultants' ability to work for other providers of NHS-funded services in their non-contracted hours should relate to these two issues. Further, it was recommended that the nature of these restrictions should be limited in scope so as to achieve their underlying aim, and to ensure that the benefits to patients and taxpayers of these restrictions outweigh their costs.

### 4.3 Competition law data since 2013

339. Monitor assumed its concurrent competition law powers in April 2013. The information below therefore relates to the period since April 2013.

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): year since 2013	
<b>Number of complaints</b> <sup>142</sup>	1
<b>Number of investigations formally launched</b>	N/A
<b>Number of those cases in which:</b>	N/A
- information gathering powers were used	N/A
- powers to enter premises/conduct dawn raids were used	N/A
- a Statement of Objections was issued	N/A
<b>Number of those cases that resulted in:</b>	
- an infringement decision	
- the giving of commitments or undertakings to change conduct	N/A
- an exemption or clearance decision (or equivalent)	N/A
- case closure without full resolution	N/A
<b>Number of cases that are ongoing</b>	
<b>Number of cases in which the decision was appealed to the CAT</b>	N/A

Monitor receives regular contact and requests for informal advice on procurement and competition issues. It considered one potentially relevant complaint but decided that it would not have been appropriate to use its concurrent powers.

<sup>142</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions.

Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: year since 2013

Number of market studies <sup>143</sup> initiated	0
Number of studies/reviews that resulted in	
- the giving of undertakings	N/A
- a market investigation reference to the Competition Commission	

## 5. Looking ahead

340. Issues in relation to health care services in England that will be a focus of consideration in the year ahead and beyond include ensuring that procurement, choice and competition bring about better care for patients,<sup>144</sup> including by:

- working to raise awareness and understanding of the benefits to be gained from good procurement practice and investigating potential breaches of the rules governing the procurement of NHS health care services
- providing insights into how and whether choice and competition are operating effectively in different health care markets and what this means for patients – including by publishing working papers on different aspects of health care markets and drawing on intelligence from Monitor’s case work and informal advice service
- measuring the extent to which patients are being offered choice in line with their rights under the NHS constitution
- taking action to protect choice and prevent anticompetitive behaviour when it is in the interests of patients to do so, including by applying and enforcing sections of the provider licence related to integrated care and choice and competition<sup>145</sup>

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<sup>143</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

<sup>144</sup> Monitor, *Business Plan 2013/14*, August 2013, page 10.

<sup>145</sup> Monitor, *Business Plan 2013/14*, August 2013, pages 16–17.

## H. Railway services – the ORR (Office of Rail Regulation)

341. The ORR is the main safety and economic regulator of railways in Great Britain.

### 1. General market conditions

342. The privatisation of the railway industry in Great Britain in 1993/94 resulted in the break-up of British Rail, effectively the monopoly provider of all railway services in Great Britain, into various separate elements:

- *The network (track and related infrastructure, including the largest main line stations):* This is owned and operated effectively as a monopoly. The owner and operator was initially a privately-owned public limited company, Railtrack, but following financial and operational difficulties encountered by Railtrack in the early 2000s, is now Network Rail, a statutory corporation created as a ‘not-for-dividend’ company limited by guarantee. Network Rail derives its revenue primarily from charges for access to its network and stations (imposed on the train-operating companies and regulated by the ORR) and from a direct financial ‘network grant’ from government.<sup>146</sup>
- *The train operators*, which subdivide into:
  - *Passenger train operating companies (TOCs):* The majority of these are franchisees, granted franchises by the Government for a period of several years to operate passenger train services on a major route or set of routes (eg the main line from London to south-west England and south Wales) or in a particular region. There is competition *for* this market, in that the franchises are granted following a competitive tender based on bidders’ commitments as to service quality and as to the extent to which they will pay for the franchise or to which they require government subsidy. In addition, franchisee TOCs face a degree of competition *in* the market from non-franchisee operators who are granted the right to compete on certain routes or networks as ‘open access’ operators; the ORR grants such rights only if the new entrant will not be primarily abstractive, ie it will generate new-to-rail business rather than merely abstracting business from existing operators. Currently, First Hull Trains and Grand Central Railway, both competing against the franchisees on certain East Coast routes, have open access rights. Retail prices are not regulated by the ORR, but, in the

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<sup>146</sup> With effect from 1 September 2014, Network Rail will be reclassified as in the public sector for statistical purposes, following a decision of the Office for National Statistics.

case of franchisees, some fares are governed by the terms of their franchise agreements with the Government.

- *Freight operators*: Freight operations in Great Britain are entirely open access, ie they are not franchised operations, allowing for competition 'in', rather than 'for', the market. Currently the market consists of nine freight companies which compete with each other to varying degrees to win contracts for the transport of goods to and from various destinations in Great Britain and Europe.
- *Providers of rolling stock*: The train operators typically lease rolling stock, primarily from the three rolling stock companies (ROSCOs) that inherited rolling stock from British Rail on privatisation – Angel Trains, Eversholt Rail and Porterbrook. There is a degree of competition between them (although constrained by availability and differences in the interoperability of rolling stock with train operators' requirements) and with new entrants such as QW Rail Leasing. These are not subject to direct regulation

343. There are many highly competitive markets in rail, including, as noted above:

- the competition to win the right to run franchises to be passenger train operators ('competition for the market')
- competition between franchised passenger TOCs on a small number of overlapping routes
- competition between franchised passenger train operating companies and open access operators; the ORR seeks to promote such on-rail competition through an approach to access applications that takes the full benefits of competition into account
- competition between freight operators
- competition between rolling-stock providers
- competition more broadly in the supply chain that serves Network Rail

344. The rail sector is characterised by a number of distinct features that affect competition, including that:

- (a) There are large monopoly elements especially in the ownership of the bulk of Great Britain's national rail infrastructure by Network Rail which, although becoming more efficient, remains much larger and more complex than comparable infrastructure businesses. As the owner and operator of the national rail infrastructure, Network Rail has a key role to

play in railway safety and improving railway performance and efficiency. It operates, maintains, renews and develops the infrastructure to deliver the outputs that governments (and other funders) wish to buy.

- (b) Competition for the market in the form of franchise auctions through which the governments in London and Edinburgh choose to procure a socially-desirable level of train services which the market would not necessarily provide. Franchisees are regulated through contracts by the Department for Transport and Transport Scotland acting as wholesale procurers of rail services. This has an important impact on the potential for competition in parts of the sector, particularly on-rail competition for passengers, and reflects the natural tension between the benefits that competition may provide passengers, with the need for government to get value for taxpayers by maximising returns from franchises.
- (c) The mixed use of private and public funding is more complex than in most sectors. Industry revenues are much lower than costs and direct public funding makes up around one-third of the industry's income, imposing a large ongoing cost to taxpayers. This directly funds the level and quality of service, finances investment in infrastructure, and subsidises some fares as governments purchase wider social, environmental and economic benefits that the market may not otherwise fund.
- The support of government and other funders will always be an important part of shaping what the railways look like. The role of government is central, in assessing what the country wants from its railways, and the services and capacity which are in the interest of promoting growth, connectivity and environmental benefits, which may not be profitable for the market to deliver.
  - The dependence of rail on a large block subsidy from government through the 'network grant' is also a significant influence across the sector. It undermines commercial decision making, with many decisions on the detail of delivery being taken centrally by government, rather than driven by the demands of the demand side. This is not consistent with rail businesses shaping solutions that reflect their understanding of the markets they serve.
- (d) There is significant cross-subsidy from infrastructure to services, with the result that value and risk do not always follow the flow of funds, causing

significant misalignment of usual customer-client relationships throughout the sector.<sup>147</sup>

345. However, if the industry can deliver on the efficiency challenge that now faces it, there is the potential to transform this so that it becomes less dependent on subsidy (beyond the specific services and capacity funders still choose to buy) and the industry can become freer to take its own decisions on how best to meet the needs of its market and to grow demand – potentially with less intervention from the ORR and government.
346. Already the way that rail infrastructure is provided and managed is undergoing a period of change, with new models of infrastructure delivery and operation being developed in different areas of Great Britain. For example, Network Rail is:
- reorganising to devolve operational control to its routes, shrinking management chains and bringing services closer to its customers
  - moving toward more alliancing which promotes closer working between track and train
347. Initiatives such as these have the potential to change the shape of regulation by:
- enabling greater use of comparative regulation
  - increasing transparency in the drivers of performance and costs
  - addressing previous divergences in incentives creating the conditions for efficiency and operational flexibility and innovation
348. The ORR will also be working with Network Rail to develop indicators to measure its system operator capability – how well it plans and timetables the network and balances competing customer needs. This is intended to lay the foundations for better use of network capacity in the future. Effective system operation may also allow the ORR to intervene less in decisions on network access.

## **2. The direct regulation regime in the sector**

349. The ORR's principal economic direct regulatory functions are set out in the Railways Act 1993, as amended.

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<sup>147</sup> ORR, *Opportunities and challenges for the railway – the ORR's long-term regulatory statement*, July 2013, pages 9–10.

350. In summary, they are to:
- regulate Network Rail's stewardship of the national rail network
  - license operators of railway assets (the network, stations and light maintenance depots)
  - approve access by parties to track, stations and light maintenance depots
  - keep under review the provision of railway services
351. The ORR also has obligations which arise under EU law. The Railways Infrastructure (Access and Management) Regulations 2005, implementing EU legislation, allow for, among other things, a right of appeal to the ORR for any applicant that thinks it has been wrongly denied access to a facility or service or that the terms for obtaining access are unreasonable or discriminatory. Appeals can also be brought against an infrastructure manager's charging system, or charging matters associated with access to unregulated facilities or services. The Regulations also impose on the ORR a duty to monitor and determine complaints relating to competition in the rail services markets where it believes that parties have been treated unjustly, been the subject of discrimination or been injured in some other way. The ORR may act following receipt of complaints or on the basis of information gathered on our own initiative and must 'determine measures and take appropriate action to correct those developments'. The ORR also licenses train operators under The Railways (Licensing of Rail Undertakings) Regulations 2005.
352. The ORR holds Network Rail to account for management of the network by enforcing compliance with its licences. This requires Network Rail, among other things, to satisfy the reasonable requirements of its customers and funders to the greatest extent reasonably practicable in its operation and development of the network. These requirements include the outputs specified in a periodic review (disaggregated for Scotland), firm commitments made in Network Rail's delivery plan and effective communication with customers and funders about delivery of those commitments.
353. The licences held by train operators (both passengers and freight) are relatively light and have no provisions that would encroach on the realm of competition law.<sup>148</sup> (The main price and service standard obligations on passenger train operators are set out in their franchise agreements with the Government, and are enforceable under those agreements rather than by the

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<sup>148</sup> The licence provisions that overlapped with competition law were removed following the coming into force of EU Regulation 1/2003.

ORR.) The ORR has a role, however, in promoting better outcomes for consumers in the gaps where competition and consumer law are imperfect tools. For example, the licence obligations on passenger train operators contain provisions that:

- preserve network benefits such as the requirement on all train operators to sell through tickets (a journey that requires more than one train and potentially more than one operator) and to act impartially in the sale of the tickets of other train operators
- require train operators to provide appropriate, accurate and timely information to enable those travelling to plan and make journeys with a reasonable degree of assurance, including when there is disruption<sup>149</sup>

### **Exercise of the ORR's licence enforcement functions**

354. The ORR took formal action under a licence only once in 2012/13. This was in relation to a Network Rail failure to deliver performance targets for the Long Distance and London and the South East sectors. Network Rail was found to have breached Condition 1 of its network licence. The ORR, in this case, decided not to impose penalties.

### **Codes of Practice**

355. The ORR has as an objective to deliver effective, timely and proportionate regulation, where appropriate looking to industry-led solutions. It has executed this in 2013/14 by the acceptance of 'commitments' in the form of Codes of Practice in:

- The freight facilities market where the ownership of key sites by incumbent operators had the potential to create barriers to effective entry and competition. Here the ORR accepted an industry-delivered short-term solution which in the longer term will be addressed by forthcoming EU legislation<sup>150</sup> which will create obligations around ownership of assets by those who also compete in the downstream market.
- The market for real-time train information, where ownership of an essential upstream input (real-time train information data) entails that there is significant market power in the hands of one party and, therefore, a responsibility on that party to demonstrate that it has processes in place not to abuse that position (eg by distorting the downstream market for

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<sup>149</sup> A provision introduced by the ORR in 2012 following concerns that passengers were becoming increasingly dissatisfied with the quality and consistency of information provided to them particularly during disruption.

<sup>150</sup> Recast EU Directive 2012/34/EU establishing a single European railway area.

consumer information products such as real-time train information phone apps and other real-time train information products). Here the ORR accepted an industry-delivered solution where the presence of intellectual property rights made competition intervention less effective. In 2013/14 the ORR asked the industry Railway Delivery Group to implement a more open data approach, failing which the ORR will establish a multi-stakeholder task force with an independent chair to deliver a solution that delivers more certainty in this market.

- The retailing of tickets. Following two earlier studies on ticket complexity and the passenger experience and passenger awareness of refund and compensation rights, in 2013/14, the ORR is commencing discussions with the industry on a Retail Code. This Code will set out the information that retailers need to supply when selling tickets and raise passengers' awareness of the quality of service they should expect to receive.

## **Transparency**

356. Rail is a complex industry and its finances and operations can be difficult to understand. Although 60 per cent of rail finances come from fare-paying passengers, the industry still receives significant sums of public money. The people who pay for the railways – whether as passengers or as taxpayers – have a legitimate interest in getting better information about how their money is spent and how the industry performs. Transparency of data is also an important part of the ORR's work as economic and safety regulator and helps the ORR to hold the industry to account.
357. The publication of financial and performance data also has an important role to play in helping to raise standards, giving businesses an incentive to improve in relation to their peers.
358. Passengers need accurate information on journey times, punctuality and reliability; clear information on fares and ticketing; information on disruption to services and how they will be affected; and a better understanding of their rights when things go wrong. This enables better planning of journeys and the exercise of more informed choice when selecting what ticket to buy and when to travel, even where choice in itself is limited due to limited competition between providers. The ORR's work on the Retail Code has the objective of ensuring that passengers and those intending to travel will have much clearer information about the service that they are buying and what they should expect from their service provider.
359. The ORR's regular data releases and reports include material on:
- Passenger and Freight Rail Performance

- Customer complaints
  - Passenger Rail Service Satisfaction
  - Key Safety Statistics
  - Great Britain rail industry financial performance providing information about the industry's value for money for its funders, both passengers and the taxpayer
  - Annual efficiency and finance assessment of Network Rail – showing how the company is delivering against its efficiency targets
  - Annual report to Network Rail's remuneration committee on financial and operating performance to inform their decisions on executive bonuses
  - Annual Health and Safety report and key safety statistics
360. As the industry moves into a new five-year investment period for Network Rail, the ORR will also enhance the information it publishes on Network Rail's performance. For example, the ORR's regular Network Rail Monitor will carry more disaggregated information so that its stakeholders can see more clearly how the company is performing at route level. The ORR will also publish an annual 'whole industry' scorecard and report so that the public can see clearly how the whole sector is performing.

### ***2.1 Using direct regulation to promote competition***

361. As described above, the ORR can, and does, allow a degree of competition 'in' the market for passenger train services under the 'open access' regime allowing new entrants in certain circumstances to compete directly against franchisee train operators. As noted above, such new entry is allowed only if will not be primarily abstractive, ie if it will generate new-to-rail business rather than merely abstracting business from existing operators.
- The ORR's duty to promote competition (see below) was key to its decision, in May 2013, to approve an application made by the open access operator, Grand Central, to introduce an additional service in competition with the incumbent franchised operator.
  - Also in 2013 the ORR considered whether to be more permissive of open access by relaxing the 'not primarily abstractive' requirement, possibly in return for the open access operator paying a mark-up as a contribution to Network Rail's fixed costs. Following consultation, however, the ORR

decided to retain the ‘not primarily abstractive’ requirement, but said that it would review the operation of the requirement.<sup>151</sup>

- In its long-term regulatory statement of July 2013, the ORR envisaged the possibility of more competition ‘in’ the market in the future:

There is an opportunity for there to be much greater on-rail competition in the future, if governments desire it. The addition of new capacity, including HS2, and the introduction of new signalling technology that allows much more dense use of network capacity, will open up new route paths that could allow greater on-rail competition between operators.<sup>152</sup>

362. Although in recent years the ORR has moved away from excessive scrutiny of the detail of the contracts between train operators and the infrastructure provider, the ORR still plays a critical role in ensuring that decisions on competing calls for limited capacity between open access and franchised operators, and between franchised operators, are made in the best interests of the passenger – that is reflecting the best overall interests of passengers, freight customers and taxpayers. For example, in July 2013 the ORR refused an application from a franchised operator, Virgin Trains, to introduce services from London to Shrewsbury and from London to Blackpool on the basis that capacity was constrained and any new services would have an unacceptably negative impact on the performance of current services to the overall detriment of those travelling.
363. Other ORR initiatives also help promote competition – including the Codes of Practice described above which seek to increase transparency about the terms of access to critical facilities, and the transparency measures which, among other things, aim to provide information to empower consumers to create ‘corrective signals’ from the demand side of the market.

### **3. The competition law regime in the sector**

#### ***3.1 Duty to promote competition?***

364. In exercising its functions under the Railways Act 1993, the ORR must consider and achieve an appropriate balance between its 24 statutory duties, one of which is to ‘promote competition in the provision of railway services for

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<sup>151</sup> ORR, *Periodic Review 2013: Final determination of Network Rail’s outputs and funding for 2014–19*, October 2013, paragraphs 16.492–16.514.

<sup>152</sup> ORR, *Opportunities and challenges for the railway – the ORR’s long-term regulatory statement*, July 2013, page 12.

the benefit of users'<sup>153</sup> of railway services. The ORR has no primary duty relating to the consumer or to competition.

### **3.2 Concurrent powers?**

365. The ORR has powers to enforce the competition prohibitions in the Competition Act 1998, and to make market investigation references under the Enterprise Act 2002, in relation to the supply of services relating to railways.<sup>154</sup>

### **3.3 Duty to consider competition law before taking direct regulatory action?**

366. From April 2014, the ORR will, as a result of Schedule 14 to the ERA13, be under an obligation, before exercising its direct regulatory powers of licence enforcement, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its powers to enforce the competition prohibitions).

367. Until now, the ORR has been subject to a broadly similar, if perhaps lesser, obligation; the Railways Act 1993, section 55(5A), provided that the ORR is relieved of its duty to take enforcement action under its direct regulatory powers 'if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998'.

## **4. Applying competition law in the sector**

### **4.1 Current approach**

368. The ORR has set out in its long-term regulatory statement<sup>155</sup> its objective to move away from regulation where market mechanisms are working or can be made to work effectively to the benefit of users and funders of the railways. This is subject to certain constraints on competition, and the dependence of some aspects of the rail sector on government support, which limit the full operation of market mechanisms. But the overall objective was reaffirmed in November 2013 by Richard Price, the ORR's Chief Executive:

Though Network Rail, the Britain's principal infrastructure manager, has no direct competitors, passenger operators face competition through the franchise process and we encourage open access entrants to the market – where it is in the interests of

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<sup>153</sup> The concept of 'users' of the railways includes passengers but is not limited to them.

<sup>154</sup> Railways Act 1993, section 67.

<sup>155</sup> ORR, *Opportunities and challenges for the railway – the ORR's long-term regulatory statement*, July 2013.

customers and taxpayers ... we want to raise the level of competition in the rail markets.<sup>156</sup>

## 4.2 Recent (and ongoing) competition law cases

### Rail freight – 2013

369. In November 2013, the ORR launched a competition investigation into the carriage of freight by rail based on a suspected infringement of the Chapter I prohibition on anticompetitive agreements and the Chapter II prohibition on abuse of a dominant position, and the equivalent EU prohibitions.<sup>157</sup>
370. The investigation was initiated by a site visit under section 27 of the Competition Act 1998 which was a joint exercise involving both the ORR and OFT officers. OFT officers provided the ORR with up-to-date experience in conducting site visits and played an important role in helping the ORR to preserve evidence (consistent with section 27(5)(f) of the Competition Act) by the use of forensic IT techniques.

## 4.3 Competition law data 2005 to 2013

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2005-2013	
<b>Number of complaints</b> <sup>158</sup>	4
<b>Number of investigations formally launched</b>	3
<b>Number of those cases in which:</b>	
- information gathering powers were used	4 <sup>159</sup>
- powers to enter premises/conduct dawn raids were used	2
- a Statement of Objections was issued	1
<b>Number of those cases that resulted in:</b>	
- an infringement decision	1 <sup>160</sup>
- the giving of commitments or undertakings to change conduct	0
- an exemption or clearance decision (or equivalent)	2
- case closure without full resolution	0
<b>Number of cases that are ongoing</b>	1
<b>Number of cases in which the decision was appealed to the CAT</b>	0

<sup>156</sup> 'Railway market opening across Europe: striking the right balance between national and European regulatory bodies', speech by Richard Price at the EU Rail Congress, 13 November 2013.

<sup>157</sup> ORR, *Competition issues – Current investigation – An investigation into the carriage of freight by rail* (last updated on the ORR website, January 2014: [www.rail-reg.gov.uk/server/show/nav.2202](http://www.rail-reg.gov.uk/server/show/nav.2202)).

<sup>158</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions.

<sup>159</sup> This includes using the powers in an investigation formally launched before 2005 (and therefore not included in the figure for number of investigations formally launched), which related to conduct by English Welsh and Scottish Railway Ltd (EWS) in the carriage of coal by rail in Great Britain (launched in 2001).

<sup>160</sup> This is the case referred to above (launched before 2005, but decided in 2006), concerning conduct by English Welsh and Scottish Railway Ltd (EWS) in the carriage of coal by rail in Great Britain.

#### Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2005–2013

<b>Number of market studies</b> <sup>161</sup> <b>initiated</b>	3
<b>Number of studies that resulted in</b>	
- the giving of undertakings	0
- a market investigation reference to the Competition Commission	1

## 5. Looking ahead

371. Issues in relation to railway services that will be a focus of consideration in the year ahead and beyond include:

- how best to make use of the enhanced concurrency arrangements in connection with the ORR's Competition Act investigation into rail freight (referred to in Section 4.2 above)
- influencing the development of EU proposals to liberalise the passenger rail market<sup>162</sup>
- reviewing the operation of the 'not primarily abstractive' rule in the context of open access for competition in the market for passenger train operations<sup>163</sup>
- the ORR working with Network Rail to develop indicators to measure its system operator capability; effective system operation may allow the ORR to intervene less in decisions on network access
- the review of the rail retail market which the ORR launched in February 2014; the purpose of the review is to consider how current regulation and industry arrangements and practices within the retail market are facilitating choice and, in particular, promoting investment and innovation in the best interest of passengers<sup>164</sup>

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<sup>161</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

<sup>162</sup> ORR, *Opportunities and challenges for the railway – the ORR's long-term regulatory statement*, July 2013, paragraph 4.41.

<sup>163</sup> ORR, *Periodic Review 2013: Final determination of Network Rail's outputs and funding for 2014–19*, October 2013, paragraph 16.514.

<sup>164</sup> ORR, *Retail market review for selling tickets – call for evidence*, 19 February 2014.

## **I. Water and sewerage services in England and Wales – Ofwat (Water Services Regulation Authority)**

### **1. General market conditions**

372. The period since 2009 might be considered to be the most significant and consistent attempt to promote competition in the water and sewerage industry, since its privatisation in 1989/90. Since privatisation, the delivery of water, and wastewater (ie sewerage), services to customers in England and Wales has been almost exclusively delivered by a series of regional monopoly service providers. Each of these companies has had near exclusive privilege to provide a complete 'source to tap' service to all of the customers in their geographic region.
373. Until 2009, these monopoly arrangements were largely unchallenged, with the sector being considered to a very large extent to have significant 'natural monopoly' characteristics, with only limited scope for introducing competition, although some steps were made to introduce competition in the retailing of water to large business customers (mainly very large users such as paper mills and breweries) and in the installation of pipework for water mains and sewers at new developments.
374. Now, however, proposed new legislation, the Water Bill, due to be enacted in 2014, represents a significant attempt to introduce retail competition for all non-household customers in England. Ofwat will play a central role in this strategy. Ofwat is promoting markets further by introducing separate price controls for wholesale and retail businesses, encouraging efficient water trading which should help reduce abstraction from stressed water resources. At the same time, these moves will improve the transparency of the sector and open opportunities to forms of competition 'for' the market further up the value chain.

### ***Extent of competition until now***

375. On privatisation, the ten previously state-owned regional water authorities in England and Wales were transformed into separate water-and-sewerage companies, responsible for all sewerage services in their regions and for water supplies in their regions other than in areas for which water-only companies were responsible. The 29 (mostly smaller) water-only companies were direct successors to the statutory water companies that had existed pre-privatisation.
376. The retail supply of water and sewerage services was, and remains, subject to price controls set by the regulator, Ofwat. There is direct regulation by Ofwat enforcing conditions in each water company's licence (known as an

'instrument of appointment'). Competition between water companies (whether water-and-sewerage companies or water-only companies) has been relatively marginal, although steps have been taken to increase both competition 'for' and competition 'in' the market. These steps have increased competition between the incumbent water companies and new entrants to the market, in particular by way of:

- (a) The Water Supply Licensing framework. This provides the basis for competition at the retail level (and possibly at the retail and upstream levels) in England and Wales. Since it came into force in December 2005, non-household customers that use at least 50 megalitres of water a year have been able to choose their water supplier from a range of new companies (in 2011, this threshold was reduced to 5 megalitres a year for England, but not Wales). These water supply licensees<sup>165</sup> are able to compete with the 10 existing appointed water-and-sewerage companies, and the nine water-only companies, once they have obtained the licence from Ofwat. The water supply licences are activity-based and allow entrants to compete nationally to provide either retail, or 'combined' (upstream and retail), supply services with existing incumbents (whose licences are geographically specific).

The water supply licence regime is also site-specific, and so does not apply to individual retail customers but rather the sites they inhabit. This means that large multisite customers must currently switch at site level; accordingly, even if a large retail chain has hundreds of stores across England and Wales, unless the consumption of each store is above the 5 megalitres threshold (or, in Wales, the 50 megalitres threshold), then that site will be unable to switch supplier. There are two types of water supply licence, but both only relate to water services; neither applies to sewerage services:

- retail supply licence – allowing the licensee to purchase a wholesale supply from an appointed water company's supply system and supply the premises of its customers
- combined supply licence – enabling the licensee to introduce water into the supply system and to supply the premises of its customers

The original 50 megalitres threshold was revised down to 5 megalitres in December 2011 for England (but not Wales), and Ofwat updated its guidance on water supply licences in September 2011, in anticipation of

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<sup>165</sup> There are currently eight licensees, of which two are independent water entities. There are also a number of independent applications under consideration by Ofwat.

that change. For Wales, the Welsh Government has decided to retain the 50 megalitres threshold.

- (b) The 'New Appointment and Variations' (NAV) regime. The NAV regime, which enables competing companies to provide water and/or sewerage services for a specific area in place of the former provider, was first set out in the Water Industry Act 1991. Before 2007, there was only one new appointee for a single site. However, in 2007 both SSE Water and IWN entered the water market as new appointees and there are now five appointees in total.<sup>166</sup>

Under the NAV regime, each new entrant is 'appointed' (ie granted a licence) as the water undertaker, or water-and-sewerage undertaker, for its appointed area in place of the previously incumbent undertaker. The NAV undertaker therefore takes over some of the territory previously served by the incumbent undertaker, whose area of appointment is then varied accordingly. These 'new' or 'varied' appointments can take place under any of three criteria:

- (i) 'consent' – the new appointee and the previously incumbent undertaker agree to the change; or
- (ii) 'large user' – single premises that are supplied with at least 50 megalitres of water a year in England, or at least 250 megalitres in Wales, where the customer in relation to the premises consents to the change; or
- (iii) 'unserved' – if the site is currently unserved by any water supplier (eg greenfield development sites).

In practice new appointees under the NAV regime obtain the water they supply 'wholesale' from the existing water-only or water-and-sewerage companies (in either raw or treated form) under contractual agreements. Ofwat has a role in determining the price and terms of such agreements if the parties are unable to reach agreement voluntarily.

The five current NAV appointees serve a total of 38 NAV sites in England and Wales, most of which were appointed under the 'unserved' criterion. These sites combined consist of a total of 7,710 customers, of which 7,407 are household customers and 303 are non-household customers. This represents revenue in the region of £6 million.

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<sup>166</sup> Albion Water, Independent Water Networks, Peel Water Networks, SSE Water and Veolia Water Projects.

(c) The 'self-lay' market. This market, in which building developers are entitled to choose their own contractors, rather than the local water or sewerage company, to lay the pipework for water mains and sewers, was opened under the Water Act 2003. Under the existing arrangements, entrants are dependent on the incumbent water or sewerage company, which holds information that is essential to compete with that company's downstream arm. It is also generally acknowledged that the current provisions in the Water Act 2003 are in themselves a barrier to entry (the relevant provisions will be removed by the charging provisions in the proposed new Water Act 2014).

377. In recent years Ofwat has identified some competition concerns in both the NAV and the 'self-lay' sectors. Ofwat has encouraged and promoted the development of effective competition by actively progressing 'strategic' competition cases in both contexts under the Chapter II prohibition on abuse of a dominant position. In terms of fostering further development through the water supply licence framework, this is the subject of legislative reforms which are discussed in more detail below.

### ***Current steps to introduce further competition***

378. In 2003, the water supply licence regime introduced an element of retail competition for non-household customers. However, for a range of reasons that were examined by the 'Cave review' in 2009, these legislative arrangements were not very effective. Following the completion of the Cave review the UK Government consulted on, and then introduced into the current Water Bill, the majority of the legislative changes proposed in the Cave review. These legislative changes include, among others:

- removing the 'costs principle' access pricing rules from the existing legislation (which had been identified as creating a significant barrier to competition) and thereby allowing revised access pricing and charging arrangements to be put in place which will allow for efficient entry<sup>167</sup>
- replacing the 'negotiated access' of non-price terms set out in the current legislation with a form of regulated access, lowering entry barriers to the market
- deepening the scope of the competitive regime to include both water and wastewater services

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<sup>167</sup> Removing the 'costs principle' will also give NAV appointees regulated rather than negotiated access to the network by replacing the prescriptive legislative requirements they must currently use when negotiating for a wholesale supply with a power for Ofwat to develop charging rules.

- encouraging more upstream water and wastewater trading, including opportunities for new entrants to introduce raw or treated water into the incumbents' networks.
379. Ofwat has consistently supported an early introduction of the recommendations of the Cave review (most of which required legislative change) and has similarly recommended opening the non-household retail market in stages to enable more customers to choose their supplier as expediently as possible.
380. Ofwat supported the Government's reduction of the eligibility threshold first from 50 megalitres (2,180 customers in England), to 5 megalitres (26,000 customers in England), and its intention to reduce this further to zero (serving all 1.145 million non-household customers in England<sup>168</sup>). In time, once the non-household market and its systems have developed, there can be further debate as to whether household customers should be able to choose their supplier.
381. In support of these changes, alongside the Government's Water White Paper in December 2011 and draft Water Bill in July 2012, Ofwat has been making prudent preparation ahead of the implementation phase of the reforms, including:
- introducing requirements on companies to separate their accounts, supporting cost discovery and a robust allocation of costs across different activities from 2008/09
  - changing the licences of appointed water (and water-and-sewerage) companies and amending the long-standing price control arrangements (which are prescribed in those licences) to allow for the introduction of separate retail and wholesale price controls. These will create a clear charging boundary to support the UK Government's ambitions for non-household retail choice and address some of the risks of price discrimination in that market
  - introducing new regulatory incentives to encourage the trading of water, again to address risks of discrimination
382. The current reforms proposed in the Water Bill will affect competition both in the upstream and in the downstream retail segments. Ofwat believes that the two go hand in hand to realise benefits for customers. If retail competition is coupled with an ability for companies to trade water efficiently, finding the

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<sup>168</sup> Source Defra, December 2011,

most efficient supply of water will also become intrinsic to the way in which firms compete. This should bring lower bills, not only through cheaper water but also through more efficient use of water. This is of course also environmentally beneficial.

#### *Downstream retail*

383. Ofwat expects changes to the downstream retail market and the introduction of choice for all non-household customers in England to bring about both cost efficiencies but also improvements in service, including encouraging customers to manage their demand better and use less water, benefiting the environment.

384. Ofwat's current preparatory work for market opening includes the following:

- (a) Developing clear and transparent charging boundaries to provide transparency and support entry. This includes:
  - (i) Ensuring robust and consistent cost allocation by companies as part of Ofwat's work setting prices for the 2014 price review. This will ensure costs are allocated robustly and consistently and that the retail market is defined consistently in different incumbent company areas, thereby helping to address the risks of price discrimination.
  - (ii) Setting clear and separate wholesale and retail price caps on incumbent companies and requiring companies to set and publish separate wholesale and retail charges to provide entrants with clear and transparent access prices. This will support the setting of tariffs that allow efficient entry and do not create a margin squeeze preventing other companies from entering the market.
  - (iii) Investigating the scope for standardising wholesale charges. Wholesale charges will always need to reflect the differences in underlying costs and geography, but there may be scope to standardise wholesale charging structures, making it easier for retailers to enter the market and provide consistent services to multi-site customers across several regions.
  - (iv) Developing clear and consistent market rules. For the market to work effectively and for new entrants to be able to enter on clear terms removing previous barriers of 'negotiated access', a clear and standard set of market rules will need to be developed (such as a code) setting out how the market operates for all participants.

- (v) Barriers to exit: Ofwat has advocated a change to the existing Water Bill to allow retail exit (the current Water Bill would not allow inefficient incumbents to exit the market by virtue of the licensing arrangements). Ofwat sees this as a crucial amendment to create an effective market.
- (vi) Ensuring market design is effective: The market structures should encourage quick and easy switching for customers. Ofwat is currently participating in work on the design of the retail and upstream markets through the 'Open Water' programme and seeking to learn the lessons from other utility sectors where competition has been introduced, including Scotland.

#### *Upstream storage: enabling efficient water trading*

- 385. In advance of enactment of the Water Bill, Ofwat has made prudent preparations by seeking to reduce the barriers to interconnection and water trading between the incumbent monopoly companies. By removing such barriers, Ofwat hopes to encourage the incumbent companies to make more efficient, resilient and environmentally sustainable choices about how they use water resources.
- 386. Although these upstream reforms will take more time to develop, Ofwat has so far undertaken work to support greater cost discovery among companies through their regulatory accounts.
- 387. Ofwat has also undertaken and participated in a range of studies into the barriers to more water trading and what can be done to address them; as well as developing a model contract to reduce the costs and risks of contract negotiation. In future annual concurrency reports, Ofwat expects to report on the progress made with regard to these reforms.

#### *Upstream distribution*

- 388. Many of the points about upstream storage discussed above apply also to distribution. Ofwat faces challenges associated with regulating what remains a largely monopolistic part of the water value chain. The sector is very capital-intensive in nature and asset lives are considerable, with some being over 120 years.

#### *Other possibilities for competition that have been considered*

- 389. The Cave review considered a range of potential further reforms that could potentially increase the role of competition in the sector (including the creation of an independent water procurement entity), but concluded that a step-by-step approach to reform was appropriate, given the lack of international

experience of some of the changes that have been proposed, and their cumulative nature.

390. The Cave review had recommended that the legal separation of the retail arms (including household and non-household retailing) from the remainder of the appointees' businesses be mandatory, other than where such separation would lead to unavoidable and unacceptably large bill increases to customers that outweighed the monetary and non-monetary benefits of such separation. This recommendation was in line with the assessment in the Interim Report of the Cave review that the experience from other sectors suggests that the real benefits of separation will only be gained with legal separation, and that the competitive market would benefit from the protection this provided against potential price and non-price discrimination.
391. However, under the reforms in the Water Bill, no companies are to be required, or enabled, to implement legal separation of their retail businesses. As the Water Bill has made its way through Parliament there has been growing support for companies to be allowed to exit from the retail market on a voluntary basis. However, at the time of writing this has not been reflected in the Bill. Ofwat will report on the outcome in the next concurrency report.

## **2. The direct regulation regime in the sector**

392. As described above, the water-and-sewerage companies and water-only companies are subject to direct regulation by Ofwat under the conditions of their licences ('instruments of appointments') including retail price controls from 2015 and service standards.

### ***2.1 Using direct regulation to promote competition***

393. Ofwat is encouraging the development of the regulatory framework to exploit the benefits of competition 'for' the market. An example where competition 'for' the market could be put to test is the Tunnel. The Thames Tideway project is a very large and complex infrastructure project. It has a risk profile very different from other capital investments delivered since privatisation. These characteristics led Thames Water, at the behest of the Government and Ofwat, to lift the historic presumption that all water infrastructure investment should be undertaken by the incumbent. Thames Water is undertaking competitive tendering exercises to this end.
394. The Flood and Water Management Act 2010 provides that certain large and complex projects may be delivered by a third party infrastructure provider, which may be regulated by Ofwat. Using this approach will require Thames Water to put the Thames Tideway project out to tender and allows Ofwat to issue a licence to the successful bidder. It is envisaged that both the cost of

finance and the construction elements of the project will be competitively bid for and that the project should be delivered in a way that is structurally separate from Thames Water. Given the characteristics mentioned above, the Thames Tideway project could become a potential test case for the sector using the market in this way.

## **2.2 A level playing field**

395. Looking ahead to the introduction of non-household retail competition, Ofwat has said that, in order for the benefits of liberalisation under the Water Bill to be realised:

it is essential that there is a level playing field between companies already in the market ('appointed companies') and those entering the market ('new entrants'). A level playing field is required if market entry is to be viable and attractive to new entrants, and will also protect against the risk of anticompetitive behaviours that could reduce the delivery of benefits to customers and the economy.

396. According to Ofwat, such anticompetitive behaviour would include discrimination by incumbents in favour of their own services and customers, disadvantaging new entrants. Ofwat takes the view that a combination of the exercise of its concurrent powers to enforce competition prohibitions and direct regulation should ensure the existence of such a level playing field.<sup>169</sup>

397. Ofwat consulted on this approach. Responses from consultees in January 2014 broadly agreed with this emphasis on the importance of ensuring a level playing field for an effective market.<sup>170</sup>

398. A 'High Level Group' established by Government and the 'Open Water' programme<sup>171</sup> has responsibility for steering the market reform process. The High Level Group is made up of representatives of both the UK and Scottish Governments, other regulatory bodies such as the Scottish water regulator, the Water Industry Commission for Scotland, customers and industry. It has declared that a criterion of success will be that the new competitive markets

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<sup>169</sup> Ofwat, *A level playing field for the water market – a discussion document*, September 2013, page 5.

<sup>170</sup> Ofwat, *Update on preparation for a new retail market for non-household customers: Information note*, January 2014.

<sup>171</sup> The Open Water programme will deliver the market architecture, codes, any identified central systems and contract(s) needed to implement the wholesale and retail arrangements outlined in the draft Water Bill 2013/14: [www.open-water.org.uk/](http://www.open-water.org.uk/).

are 'fair, transparent and efficient', and Ministers have expressed their agreement with the 'programme vision' of which that criterion forms part.<sup>172</sup>

399. Ofwat, Government and the industry see competition law as a key tool to achieve the 'level playing field' between incumbents and new entrants that is fundamental to the success of the Water Bill reforms in making the water sector more competitive. However, although competition law is a useful tool, it will be effective competition and outcomes for customers that serves as the key criteria by which success in this area can be judged over the coming years.

### **3. The competition law regime in the sector**

#### **3.1 *Duty to promote competition?***

400. As a result of changes introduced in 2003, one of Ofwat's general duties is to further 'the consumer objective', defined as 'to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services'.<sup>173</sup> This guiding principle is reflected in all activities Ofwat conducts from comparative regulation to enforcement of cases under the competition prohibitions in the Competition Act 1998.

#### **3.2 *Concurrent powers***

401. Ofwat has powers to enforce the competition prohibitions in the Competition Act 1998 in relation to commercial activities connected with the supply of water or securing a supply of water or with the provision or securing of sewerage services. It also has powers to make market investigation references under the Enterprise Act 2002 to the CMA in relation to commercial activities connected with the supply of water or the provision of sewerage services.<sup>174</sup>
402. Ofwat does not regulate water and sewerage services within Scotland and Northern Ireland. Therefore Ofwat's concurrent competition powers in respect of the competition prohibitions in the Competition Act 1998 and the market provisions in the Enterprise Act 2002 apply only to England and Wales.

#### **3.3 *Duty to consider competition law before taking direct regulatory action?***

403. From April 2014, Ofwat will, as a result of Schedule 14 to the ERRA13, be under an obligation, before exercising its direct regulatory powers of licence

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<sup>172</sup> Open Water High Level Group, *Market reform programme – framework document*, 20 December 2013.

<sup>173</sup> Water Industry Act 1991, section 2.

<sup>174</sup> Water Industry Act 1991, section 31.

enforcement, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).

404. Ofwat has reviewed its approach in order to comply with Schedule 14 to the ERRA13 and has allocated more resources to preparing initial assessments of all complaints for early identification of potential breaches of Competition Act 1998.

## **4. Applying competition law in the sector**

### **4.1 Current approach**

405. Harnessing market forces is a key pillar of Ofwat's strategy for the sector in order to enhance benefits for customers. Anticompetitive behaviour in the water and sewerage sector leads to consumer detriment and Ofwat's concurrent competition powers, under both the Competition Act 1998 and the Enterprise Act 2002, therefore play an important part in its overall 'tool kit' and are integral to its effectiveness as a regulator.
406. That said, competition in the sector is in its infancy. It works as effectively as possible at present but there will be a step change once the non-household retail market opens in 2017 (assuming enactment of the current Water Bill). Critically, Ofwat is taking steps now through both its price controls in the price review 2014 and other direct regulatory measures to ensure market opening is a success. This includes targeting our case work to ensure that Ofwat:
- pre-empts any competition problems
  - facilitates the development of effective competition
  - enables spill-over effects from contestable markets to the non-contestable parts of the sector

### **4.2 Recent competition law cases**

407. Ofwat recognises the importance of exercising its Competition Act 1998 powers, where appropriate. Ofwat scrutinises the most appropriate use of its powers against prioritisation principles which have been consistent with those of the OFT.<sup>175</sup> Ofwat has also recently demonstrated its commitment to using its Competition Act 1998 powers. For example, it currently has two investigations in progress under the Chapter II prohibition on abuse of a dominant position. Ofwat has issued a Statement of Objections in one case, and is

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<sup>175</sup> [www.ofwat.gov.uk/competition/ca98/prs\\_inf\\_100920ca98priority.pdf](http://www.ofwat.gov.uk/competition/ca98/prs_inf_100920ca98priority.pdf).

consulting on proposals to accept commitments in the other case (see below for more detail).

408. In January 2013, Ofwat also accepted formal commitments from Severn Trent PLC, which involved the divestiture of its water testing and analytical business. This divestiture was the result of Ofwat accepting that the divestiture would both break a structural link that enabled the leveraging from Severn Trent Water's core regulated business into a contestable market, and that the commitments therefore addressed Ofwat's competition concerns.
409. In addition, in 2011, in an example of effective joint working between competition authorities and sectoral regulators, Ofwat conducted a market study jointly with the OFT (as described below).

### ***Ongoing investigations under the competition prohibitions***

#### ***Alleged margin squeeze – Anglian Water's pricing to the 'Fairfield' development in Milton Keynes***

410. In December 2011, Ofwat published a Statement of Objections alleging an infringement by Anglian Water (an incumbent monopoly provider) of the Chapter II prohibition on abuse of a dominant position. The Statement of Objections set out Ofwat's provisional view and proposed next step.
411. Competition to provide water and sewerage services to new developments to be one of the few areas of contestable activity in the sector, as facilitated by the NAV regime (see above), when this case was initiated. Potential new entrants must generally obtain 'upstream' off-site supplies from the surrounding appointed monopoly company, which in the case of the Fairfields site was Anglian Water. For the future, this issue remains of strategic importance to Ofwat as the sector moves towards market opening in 2017.
412. Ofwat's preliminary view was that Anglian Water's pricing for the Fairfields site resulted in a margin squeeze and excluded competition. Following Ofwat's Statement of Objections, the investigation has continued alongside consultation with parties. Oral hearings were held in 2012 and update meetings took place in 2013.
413. A draft decision is due to be issued in 2014. This investigation is the first Ofwat case to be considered by its new Board Casework Committee whose membership consists of two non-executive directors from the Ofwat board and one independent decision maker drawn from the OFT board (now the CMA board). This new Committee will make the final decision on whether there has been an infringement.

*Dominant undertaking imposing dissimilar conditions to equivalent transactions*

414. The second current investigation under the Competition Act 1998 is focused on a vertically-integrated incumbent water company that, it is alleged, has been abusing its dominant position as the appointed company in its area of appointment. The focus of the investigation has been on the potential leveraging of a dominant position into the contestable market of providing new water connections. Ofwat is working on this investigation with the OFT (now the CMA), which has provided an independent member to the case's project board.
415. The alleged discriminatory behaviour relates to both the price and non-price terms offered to self-lay organisations. This has allegedly had the effect of disadvantaging the self-lay route for a developer to secure new connections compared with the requisition route where the connections are provided by the water company itself. It is alleged further that this has meant the self-lay organisation concerned cannot compete effectively in the relevant economic market.
416. Ofwat's initial investigation has identified a number of price and non-price concerns where there is potential for the incumbent company to be leveraging its dominant position including by way of the calculation of quotations, the differing application of both charges and security requirements, and differences in the information and services provided by the company for the requisition and self-lay options.
417. Ofwat is currently considering commitments offered by the appointed water company. Ofwat provisionally considers that the commitments offered fully address the competition concerns Ofwat has identified for the case and Ofwat is preparing to consult publicly on its proposal to accept them. A formal decision to accept the commitments as binding would result in Ofwat closing its investigation and not proceeding to a decision on whether or not the water company in question has infringed the Chapter II prohibition. Ofwat believes that this case is appropriate for accepting commitments.
418. As well as addressing the specific competition concerns relating to this individual water company, Ofwat expects this case to deliver wider indirect benefits to the sector by highlighting the key competition concerns relevant to this contestable market and deterring anticompetitive behaviour in other areas of appointment. Ofwat also intends to use it to highlight the increasing importance of level playing field issues for vertically integrated undertakers as competition in the industry grows over the coming years.

## **Market studies**

### *Anaerobic Digestion (sludge) – 2011*

419. Ofwat approached the OFT with a request to undertake a market study to gain understanding of the interaction between sludge treatment, recycling and disposal services and the wider organic waste markets.
420. The OFT agreed with Ofwat's approach and a joint market study was launched in January 2011. This joint study was a success and Ofwat considers it to be a flagship project in terms of exploring partnership working of this nature going forward.
421. The OFT led on the study, using its experience in conducting market studies and its recent review of the municipal, commercial and industrial organic waste sectors. Ofwat closely supported the OFT by providing sector-specific and technical expertise. This collaboration made the study team more effective, enabling sharing of best practice and best use of the skills in each organisation. Feedback suggests this approach has a great deal of merit and was highly successful; there was rapid interchange between the two authorities resulting in considerable time-saving throughout the market study process.
422. The recommendations proposed changes to the economic regulation of water-and-sewerage companies to foster efficiency and help create a level playing field between them and other suppliers of organic waste treatment. The study also recommended greater harmonisation of the environmental regimes applicable to sewage sludge and other organic waste. It was also considered that planning policy proposals then under consideration could contribute to greater competition.
423. The OFT did not consider that a market investigation reference to the Competition Commission was warranted. However, Ofwat has been able to take forward the recommendations in respect of its work on the 2014 price review.
424. In particular, in its methodology statement for the 2014 price review Ofwat set out its proposals to implement incentives to support the provision and publication by water companies of regular disaggregated information in the next price control period.<sup>176</sup> Specifically: the costs, revenues and management arrangements of its monopoly wastewater treatment and network activities, as distinct from the contestable sludge activities.

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<sup>176</sup> [www.ofwat.gov.uk/pricereview/pr14/pap\\_pos201307finalapproachapp4.pdf](http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproachapp4.pdf).

425. The improved information is intended to provide transparency to market participants, and promote more effective competition in the contestable area, and to inform the setting of more focused price controls for the less contestable activities.

### ***Closed competition prohibition cases***

#### ***Southern Water Services Ltd – Provision of new infrastructure in East Kent – August 2004***

426. Ofwat received a complaint under the Competition Act 1998 from Mid Kent Water against Southern Water. The complaint related to the terms offered by Southern Water to a developer, Rosefarm Estates, for the provision of water, wastewater and infrastructure services to a development site in Southern Water's supply area, the EuroKent Business Park.
427. Mid Kent and Southern Water were in competition for the provision of the services. Mid Kent alleged that Southern Water's conduct breached the Chapter II prohibition on abuse of a dominant position when an offer was made to Rosefarm to provide sufficient capacity to satisfy the entire water demand of EuroKent without any charge for off-site works.
428. Southern Water had at earlier stages stated that the cost of works to supply the site could be between £100,000 and £500,000. Mid Kent alleged that Southern Water's offer to supply without charging for the off-site works was 'effectively predatory pricing' and 'discriminatory'.
429. After carrying out an extensive investigation, Ofwat decided that Southern Water's conduct was not caught by the Chapter II prohibition, and therefore there are no grounds for action. In particular, Ofwat saw no sufficient reason to doubt that Southern Water's suggestion in correspondence with Rosefarm, that a dedicated main from its Fleete Reservoir to EuroKent would be necessary, was based on a misunderstanding of what EuroKent's requirements were likely to be. Ofwat also observed that there appeared to be no legal basis on which Southern Water could have then sought a contribution from Rosefarm towards its off-site work.

#### ***Investigation into charges for the treatment of tankered landfill leachate by United Utilities following a complaint made by Quantum Waste Management – May 2005***

430. Quantum Waste Management (QWM) is a brokerage company that collects and disposes of landfill leachate at waste water treatment works and other sites. QWM made a complaint concerning Bioprocessing (an arm of United Utilities), which receives tankered waste on behalf of United Utilities at its waste water treatment works.

431. QWM alleged that United Utilities' conduct in the market for the treatment of tankered landfill leachate breached the Chapter II prohibition on abuse of a dominant position. After a thorough investigation, Ofwat did not find sufficient grounds to issue a statement of objections to United Utilities. The prices charged did not indicate predation or a margin squeeze; there was no evidence of selective discounting; and there was no evidence of denying access to treatment works (ie no refusal to supply).

*ALcontrol Laboratories – 2012/13*

432. Ofwat received a complaint from ALcontrol Laboratories alleging that Severn Trent Laboratories had won contracts to supply water analysis services to South Staffordshire Water and Yorkshire Water by pricing below any relevant measure of cost. The complaint alleged that this infringed the Chapter II prohibition and that Severn Trent Water had leveraged its dominant position in the provision of water and sewerage services within its area of appointment, into the potentially competitive water analysis market.
433. ALcontrol Laboratories alleged that the below-cost pricing had been funded by higher levels of pricing by Severn Trent Laboratories to Severn Trent Water, Severn Trent Laboratories' sister company. ALcontrol Laboratories considered that the result was the withdrawal of a competitor from the market, thereby substantially reducing competition in the market and increasing Severn Trent Laboratories' market power. Accordingly, Ofwat had a choice to investigate this complaint either under its direct regulatory powers (potential cross-subsidy in breach of licence conditions) or under the Competition Act 1998. Ofwat choose to investigate this issue under the Competition Act 1998.
434. On 8 March 2012, Severn Trent approached Ofwat with an offer of commitments which it considered addressed Ofwat's potential competition concerns. Severn Trent offered a structural divestment of the Severn Trent Laboratories business. The divestment would break a key structural link which would have facilitated the alleged leveraging of a dominant position and address Ofwat's main competition concern.
435. Following a period of negotiation between Severn Trent and Ofwat, in August 2012 Ofwat consulted on its intention to accept, from Severn Trent, binding commitments under the Competition Act 1998. In summary, these commitments:
- required Severn Trent to in-source its water analysis services and rescind its contract with Severn Trent Laboratories

- required Severn Trent Group to divest the remainder of Severn Trent Laboratories (and put in place arrangements to, as far as possible, ensure an expedient sale)
- precluded Severn Trent (or any associate company) from operating as a commercial water analysis services provider

436. The consultation did not raise any material issues and Ofwat considered that the potential competition concerns could be addressed through accepting the commitments that Severn Trent offered. In particular, the nature of the commitments meant that the structural link that had given rise to the potential competition concerns would be removed. The commitments took effect from January 2013.

### 4.3 Competition law data 2005 to 2013

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2005-2013	
<b>Number of complaints</b> <sup>177</sup>	13
<b>Number of investigations formally launched</b>	3
<b>Number of those cases in which:</b>	
- information gathering powers were used	3
- powers to enter premises/conduct dawn raids were used	0
- a Statement of Objections was issued	1
<b>Number of those cases that resulted in:</b>	
- an infringement decision	0
- the giving of commitments or undertakings to change conduct	1
- an exemption or clearance decision (or equivalent)	1
- case closure without full resolution	8
<b>Number of cases that are ongoing</b>	2
<b>Number of cases transferred</b>	1 (transferred to the FCA as a consumer case)
<b>Number of cases in which the decision was appealed to the CAT</b>	0

Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2005-2013	
<b>Number of market studies</b> <sup>178</sup> initiated	1
<b>Number of studies that resulted in</b>	
- the giving of undertakings	0
- a market investigation reference to the Competition Commission	0
- recommendations to government	1

<sup>177</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions.

<sup>178</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission.

## 5. Looking ahead

437. Issues in relation to water and sewerage services that will be a focus of consideration in the year ahead and beyond including how best to achieve the competitive outcomes envisaged in the Water Bill, particularly:

- developing market arrangements that allow all non-household customers to choose their retail supplier, while at the same time ensuring they have effective protection
- publishing updated guidance on which customers we consider are eligible to choose their retail water and wastewater supplier
- consulting on charging issues related to the implementation of market reforms
- consulting on how a level playing field can be achieved for new entrants and avoid undue discrimination
- consulting on the design of retail water licences, retail wastewater licences and retail market arrangements, including market governance and market codes (the rules and principles that suppliers must observe)
- engaging with sector stakeholders on the design of wholesale water and wastewater licences, including market governance, market codes and establishing a roadmap for reviewing licences
- consulting on changes to the standard conditions in water supply licensees' licences to remove the ban on them trading in their associated appointee's area ('in area trading ban')
- concluding Ofwat's current Competition Act 1998 casework and launching new strategic investigations where appropriate which establish important precedents for encouraging competition in England and Wales as set out in the Water Bill.

## **J. Utility services (electricity, gas, and water and sewerage services) in Northern Ireland – the NIAUR (Northern Ireland Authority for Utility Regulation)**

438. The NIAUR is a non-ministerial independent government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries.

### **1. General market conditions**

439. The nature of the Northern Ireland markets differ somewhat from the equivalent markets in Great Britain. For example, there are only around 850,000 consumers in Northern Ireland and the gas and electricity retail markets have only been opened up to new market entrants in recent years. However, competition does now exist in sectors of both the electricity and gas markets in Northern Ireland.

#### ***Electricity***

440. Following market analysis, the NIAUR has proposed an evolutionary reduction to the price-regulated threshold in the non-domestic market. The NIAUR has proposed to retain the price control for micro-enterprises, that is the 0–50 megawatt hours a year non-domestic sector; but remove coverage in the 50–100 and 100–150 megawatt hours a year sectors and thereby rely more on general competition law in these sectors.

441. In addition, a roadmap has also been proposed that will automatically trigger a further consultation on the reduction or removal of the former incumbent's price control in the 0–50 megawatt hours non-domestic market.

442. As regards domestic customers, the work regarding a roadmap to the removal of price controls for the domestic market is more complicated and other concerns, eg the impact of competition for vulnerable customers, requires further assessment. No change to the domestic market has been proposed at this point. The former incumbent retains significant market share in the domestic market.

443. This review has been scheduled in the organisation's published Forward Work Programme to commence in 2014, as the current price control project comes to an end.

## **Gas**

444. Competition for customers in the Greater Belfast area commenced in November 2010. The former incumbent retains significant market share and therefore no change to the domestic market has been proposed at this point.

## **Water**

445. Currently the incumbent is the sole monopoly provider of both water and sewerage services and there have been no moves towards introducing competition into the local marketplace. The Northern Ireland Assembly continues to subsidise local provision of services to domestic consumers, with full charging in place for non-domestic customers.

## **2. The direct regulation regime in the sector**

### ***Energy (electricity and gas)***

446. The framework within which the NIAUR operates involves (in addition to competition law powers) the application of direct ('ex ante') regulation in particular areas. In common with the rest of the UK, such regulation may derive from EU legislation, such as unbundling and third party access rules that apply in the energy industry.
447. *Unbundling*: The NIAUR applies and enforces rules requiring the separation of networks from activities of production and supply in order to prevent vertically integrated undertakings from discriminating against their competitors as regards to network access and investment. These rules originate from provisions of the EU's Third Package. The rules require certain network licensees to be certified by the NIAUR as independent in accordance with one of the applicable grounds for certification.
448. In Northern Ireland, the functions of electricity transmission system operation are currently shared between the owner of the transmission assets (and the distribution system operator) and Transmission System Operator (TSO).
449. *Third party access rules*: Open and non-discriminatory access to the networks by those who do not own the physical network infrastructure, known as third party access, is fundamental in facilitating greater competition and making energy markets work effectively. Owners and operators of the electricity networks, the TSO and the distribution system operators (DSOs), and the owners/operators of interconnectors, are obliged to provide non-discriminatory access to their lines, pipes and other facilities to third parties. The NIAUR has a formal role in approving proposed access rules submitted to it by the relevant licensee.

450. *Other forms of direct regulation:* Monopoly owners of the electricity transmission and distribution network and the gas networks in Northern Ireland are subject to a network price control to ensure customer protection. Although supply price controls have been removed in the regulated energy sector in Great Britain and recently in the Republic of Ireland, this was in the context of significantly more mature markets and competition levels, as well as much greater market size and potential for truly effective competition to protect consumers.
451. The NIAUR retains end-user price regulation only in those areas of the market where the former monopoly incumbent retains significant market power. The price regulation of the former incumbent, which is the market's price leader, removes the potential for abuse of dominance and ultimately avoids unjustified increases in customer bill:
- (a) Domestic electricity customers of the former incumbent and non-domestic industrial and commercial (I&C) customers, using up to 150,000 kilowatt hours a year, are protected by a regulated tariff control set out in the incumbent's supply licence. I&C customers above this threshold, and customers of other electricity suppliers in Northern Ireland, are not covered by the NIAUR's supply price control regime.
- (b) There are two distinct markets in gas: Greater Belfast and the Ten Towns:
- In Greater Belfast, domestic gas customers of the former incumbent and non-domestic I&C customers, using up to 732,000 kilowatt hours a year, are protected by a regulated tariff control set out in their Supply Licence. I&C customers using above this threshold, and customers of other gas suppliers in the Greater Belfast area, are not covered by the NIAUR's supply price control regime.
  - In the Ten Towns area, the incumbent is the sole monopoly provider for those consumers using less than 732,000 kilowatt hours a year. The costs of the incumbent are controlled through a Distribution Price control. The domestic market will open to competition in April 2015 and at this stage the incumbent will be subject to a supply price control.

### ***Wholesale electricity***

452. The Single Electricity Market (SEM) is a cross-jurisdictional wholesale electricity market which operates on the island of Ireland and is regulated by the SEM Committee (SEMC). The SEMC is a statutory committee of both the NIAUR in Northern Ireland and the Commission for Energy Regulation in the Republic of Ireland. A programme of work is now under way to design and

implement changes to SEM to facilitate the implementation of the requirements of the European target model for cross border capacity and congestion management.

453. The NIAUR has a Market Monitoring Unit whose job it is to monitor the SEM to ensure that generation licensees are submitting bids to the Market Operator which are cost-reflective. The NIAUR also monitors market power by using measures such as Pivotal Supplier Index and the Herfindahl-Hirschman Index.
454. Where the Market Monitoring Unit considers that a licensee may be submitting bids which are not cost-reflective, an investigation will be opened into the issue.

### ***Water***

455. Continued subsidy of water service provision has meant reclassification of the local monopoly provider with dual status, both as a GoCo (government owned company with the Department for Regional Development as shareholder) and NDPB (non-departmental public body). The local monopoly provider is subject to a network price control.

### ***2.1 Using direct regulation to promote competition***

456. The provisions on unbundling and third party access for retail energy, and the operation of the Market Monitoring Unit for wholesale electricity – described above – make use of direct regulation to promote competition.
457. The NIAUR will also use direct regulation to promote competition where it is considered appropriate to do so. For example, it is currently in the process of running a competition to award a licence to extend the natural gas network in Northern Ireland.

## **3. The competition law regime in the sector**

### ***3.1 Duty to promote competition?***

458. Where the NIAUR is considering exercising its functions it is generally required to carry out those functions in a manner it considers best calculated to further the 'principal objective', wherever appropriate by either promoting or facilitating competition.

- *Electricity*: The principal objective in electricity is to protect consumers, where appropriate by promoting effective competition.<sup>179</sup>
- *Gas*: The principal objective in gas is to ‘promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland ...’. Subject to the principal objective the NIAUR is obliged to carry out its functions in a manner which it considers is best calculated to facilitate competition.<sup>180</sup>
- *Water*: The principal objective in water is to protect consumers, where appropriate by facilitating effective competition.<sup>181</sup>

### **3.2 Concurrent powers?**

459. The NIAUR has powers to enforce the competition prohibitions in the Competition Act 1998 in relation to the activities for which it is responsible and to make market investigation references under the Enterprise Act 2002 to the CMA in relation to those activities.<sup>182</sup>

### **3.3 Duty to consider competition law before taking direct regulatory action?**

460. From April 2014, the NIAUR will, as a result of Schedule 14 to the ERRA13, be under an obligation, before exercising its direct regulatory powers of licence enforcement, to consider whether it would be more appropriate to proceed under the Competition Act 1998 (ie using its competition prohibition powers).

## **4. Applying competition law in the sector**

### **4.1 Current approach**

461. The NIAUR has already indicated to stakeholders the need for a strategic exercise to be undertaken to review the effectiveness of competition and the implications for the regulatory policy framework and the regulatory tools to be adopted by the NIAUR in that context.

462. This review has been scheduled in the organisation’s published Forward Work Programme to commence in 2014, as the current price control project comes to an end.

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<sup>179</sup> The Energy (Northern Ireland) Order 2003, article 12.

<sup>180</sup> The Energy (Northern Ireland) Order 2003, article 14.

<sup>181</sup> The Water and Sewerage Services (Northern Ireland) Order 2006, article 6.

<sup>182</sup> The Electricity (Northern Ireland) Order 1992, article 46; The Gas (Northern Ireland) Order 1996, article 23; The Water and Sewerage Services (Northern Ireland) Order 2006, article 29.

463. In January 2014 the NIAUR, in its draft corporate strategy and draft forward work programme for 2014–19, declared its first two objectives to be:
- (a) ‘to promote effective and efficient monopolies’ (ie where there is currently no competition); and
  - (b) ‘to promote competitive and efficient markets’.<sup>183</sup>

#### **4.2 Recent competition law cases**

464. There have been no recent investigations based on competition powers. Electricity and gas are relatively homogeneous products so new entrants are only able to truly differentiate themselves on price and service, not the physical product they supply. Although energy retailers are generally ‘asset-light’ in nature, there remain significant barriers to entry in the Northern Ireland market. In particular, the contestability of the energy supply markets in Northern Ireland is limited by the relatively small size of the Northern Ireland markets.
465. Not insignificant investment is required for IT and billing infrastructure to facilitate trading in the supply market. A large proportion of the ongoing running costs are fixed. Moreover, the economies of scale issue is somewhat exacerbated by the dominant incumbents in electricity and gas continuing to retain a substantial amount of customers that are loyal to their brands.
466. In electricity, there is also a substantial working capital requirement that is faced by suppliers that presents a further barrier to entry. All suppliers must post credit cover for forecast future pool purchases of electricity. Suppliers must also make payment security credits to the DNO for the distribution use of system and public service obligation, equating to approximately five weeks of charges.
467. In order to encourage competition and make the switching process easier, the NIAUR allowed the DNO cost recovery for a new IT system which in theory can facilitate unrestricted switching for electricity customers. Following ‘go-live’ in May 2012 it now takes up to a maximum of 21 days to switch electricity supplier, with approximately 5,500 domestic customers changing supplier in September 2013.

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<sup>183</sup> NIAUR, *Draft Corporate Strategy 2014–19 and draft Forward Work Programme 2014–15*, page 14.

### 4.3 Competition law data 2005 to 2013

Use of powers under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions): 2005-2013	
Number of complaints <sup>184</sup>	0
Number of investigations formally launched	0

  

Use of powers under the market provisions in Part 4 of the Enterprise Act 2002: 2005-2013	
Number of market studies <sup>185</sup> initiated	0

## 5. Looking ahead

468. Issues in relation to utility services in Northern Ireland that will be a focus of consideration in the year ahead and beyond include:

- conducting a review of the effectiveness of competition in Northern Ireland's energy retail markets
- implementing a robust Retail Energy Market Monitoring framework that adequately monitors the retail markets, informs policy and protects consumers.<sup>186</sup>

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<sup>184</sup> Note: 'Complaints' under the Chapter I and Chapter II prohibitions in the Competition Act 1998 (or equivalent EU prohibitions) refers to complaints received by the authority which the authority regarded as raising competition law issues under those prohibitions.

<sup>185</sup> Note: This relates to market studies that are public and that involved consideration of whether there should be a market investigation reference to the Competition Commission

<sup>186</sup> NIAUR, Draft Corporate Strategy 2014–19 and draft Forward Work Programme 2014–15, page 25.