Retail Energy Markets: Does competition offer enough protection?

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Retail Energy Markets: Does competition offer enough protection?

Catherine Waddams, Professor in Regulation

This article examines some of the issues facing the UK energy regulator as it attempts both to promote competition and ensure that vulnerable households are not disadvantaged in the process. Some of the remedies introduced after the 2008 Energy Supply Probe, including the non discrimination clauses, have proved to be less effective than hoped, and in some cases to have been counterproductive and to have slowed the competitive process. Both regulator and government have to choose in this highly sensitive household energy sector whether to focus on the competitive process, which is likely to lower average prices and encourage innovation, but cannot guarantee particular outcomes for given consumers; or on regulation which can protect vulnerable groups, but probably at the expense of higher prices for consumers as a whole.

In 2008 the British energy regulator, Ofgem, commenced what has proved to be a difficult path of intervention in the retail energy markets. A decade after the markets had been opened to entrants, and six years after the last price caps had been removed, their Energy Supply Probe indicated that competition was not working in the way many wished.

In particular, while switching rates were high compared to many other products, a group of ‘sticky’ consumers had stayed with the incumbent (previous monopolist) supplier in each area. This combined with the regional nature of the market (14 regions in England, Wales and Scotland) enabled the consolidated descendants of these incumbents (each previously monopolist in two or three regions) to charge more to the sticky customers in their home regions than to those they were trying to lure away from other incumbents elsewhere.

While some saw this as a fundamental dynamic of the competitive process, others were concerned that the sticky customers were being exploited, that a disproportionate number of them were disadvantaged or vulnerable customers, and that the market displayed characteristics of co-ordinated effects between the ‘Big 6’ players (the consolidated electricity incumbents and the gas incumbent, British Gas) who together supplied 99% of the residential market.

Ofgem’s 2008 Energy Supply Probe introduced a number of measures to help consumers to be more active in the market, and to address the market power of the vertically integrated big players, who were able to use the retail market to hedge against the volatility of the wholesale energy markets, which proved a major obstacle for new entrants.

On the tariff front, the Probe established that electricity companies had been charging around 10% higher mark-ups in areas where they were incumbent (mainly to consumers who had never switched supplier) than in other areas where
they were discounting to attract consumers away from other incumbents. Ofgem proposed a non-discrimination clause to prevent such differentials in mark-ups. Unfortunately, as three academics (including CCP) pointed out at the time, this could have a chilling effect on competition.

After representations from the companies, Ofgem introduced the clauses in mid-2009, with a three year ‘sunset clause’, but allowed special temporary deals for marketing purposes. They clearly hoped that by forcing the prices charged in and out of area closer together, companies would reduce the higher prices being paid by the inactive customers.

Such non-discrimination clauses are not necessarily anti-competitive, but in a paper published in The Economic Journal in July, Morten Hviid and Catherine Waddams showed that it would indeed hamper competition in the particular circumstances of the energy market.

Each of the big 5 has the majority of its customers and profits in its home areas. If it has to bring prices closer together, it will lose more profits by lowering these in area prices, than if it raises its prices in other areas, even though such price rises will mean they recruit fewer new customers. And each company knows that all the others are in the same situation. Since the only other major player, Centrica, the gas incumbent, pursues a national policy, each electricity company will profit most by focusing on its own ‘sticky’ consumers, rather than lowering their prices in order to compete strongly elsewhere. Ironically the ability to make special offers to lure customers may make things worse. Such offers had to be for a limited period of time, and at the end of the offer customers would revert to the (higher) standard offers, sometimes without realising this. Thus the exception might prove a ‘bait and switch’ trap for unwary customers, including the very vulnerable consumers who the regulator wanted to protect.

Subsequent events provide support for the economic model’s predictions. Standard prices did indeed come closer together, reducing the potential gains from switching to a new supplier, and, unsurprisingly, switching has fallen dramatically. CCP’s switching research confirms that the biggest influence on switching rates (in energy and other markets) is potential savings, so if these decline, so will switching rates. Of course prices are not the only influence, and the withdrawal from door-step selling by the Big 6 in 2010 is also a likely factor.

The graph below illustrates how both available benefits from switching (the blue line) and the amount of switching (the red line) have fallen since the non-discrimination clauses were first mooted in 2008 in one region. Switching and available offers show a significant positive relationship, though this pattern is not so obvious in every region. But nationally, switching rates have fallen dramatically for both electricity and gas, by over half between its height in mid-2008, just before price differences started to decline, and the most recent figures for the second quarter of 2012: hardly the stimulation of the market which Ofgem had hoped for. Company profits have also increased since 2008, suggesting that companies have indeed raised their lower prices rather than reduced their higher prices.

But what of the special offers? These have increased dramatically in number, introducing confusion rather than stimulating switching. Concerned by this development, the regulator published its Retail Market Review at the end of last year.
This proposed a series of remedies to enable consumers to make better choices between tariffs, including a standing charge determined by the regulator for all suppliers, to help consumers choose more easily between different offers. The related consultation elicited many responses, including several challenging the wisdom and effectiveness of such drastic intervention in a supposedly deregulated market. Ofgem paused both to consider the issues raised and to seek further evidence on the likely consequences of the proposed remedies, and have promised to outline their next steps ‘before the winter’; their proposals for next steps should be known by the time this article is published.

Meanwhile the non discrimination clauses were due to lapse in summer 2012; Ofgem initially proposing to ‘roll them over’ while the retail market review continued, but responded to evidence that they may have had harmful effects by allowing them to lapse, and continue to monitor price differentials informally.

The question facing the regulator is whether it should continue to encourage competition in the retail energy market, or ensure the protection of vulnerable consumers. For while competition usually lowers the average level of prices in a market, there is no guarantee that it will lower every price, so that each consumer benefits equally.

And by its nature, competition offers incentives and rewards to those who are active in seeking out better deals, who are not necessarily the most vulnerable or needy. Moreover, a fundamental characteristic of competitive markets is the choice of whether or not to participate. Consumers can be helped, but not forced, to take part and seek out better deals for themselves. And insights from behavioural economics show that many consumers do not choose the best deal for themselves, and providing more information may deter rather than stimulate activity.

Vulnerable consumers could be protected by regulation, though this would probably involve higher prices across the market because of the inefficiencies of any regulatory process. The final judgement, in the UK with its long experience of deregulated markets, and elsewhere where competition is just beginning, must lie with governments. They cannot eat their cake and have it, enjoying the benefits both of competition and protection; in making the choice, they would do well to recall that the road to hell is paved with good intentions.

4: Effective empowerment: Empirical estimates of consumer switching behaviour, by Catherine Waddams Price and Catherine Webster, forthcoming CCP research paper Ref to forthcoming paper with CW.
6: See Ofgem’s calculations at http://www.ofgem.gov.uk/Markets/RetMkts/mr/mr/Pages/indicators.aspx
Evaluation of Policy: the task of quantifying the unknowns: deterrence and non-detection

Stephen Davies, Professor of Economics and Peter Ormosi, Lecturer in Competition Policy

For all the considerable recent advances in techniques used to evaluate the impact of competition policy, we still know remarkably little about two major unknowns: how much anti-competitive harm is avoided because it is deterred, and how much harm is there out there of which we are blissfully unaware, because it is undetected? This article discusses some of the very real problems, revolving around selection bias, in our own current research designed to quantify these unknowns.

As economists, we are brought up, almost from the cradle, to believe that ‘competition is a good thing’, and it follows that, if effective, competition policy is a worthwhile component of any government’s expenditure. In recent years, governments and academics around the world have devoted considerable effort to estimating the impact of competition policy on the economy and on welfare, and their findings are generally very positive. For example, in the UK, the Office of Fair Trading calculates that every £1 it spends yields £10 of benefits to consumers. Evaluations by the European Union and the USA yield qualitatively similar results.

However, all such evaluations are based only on the cases that a competition authority (CA) prosecutes/intervenes in – cartels which it busts, anti-competitive mergers which it blocks or remedies, etc. We call these the ‘observed’ cases. This raises an obvious question ‘what about the unobserved cases?’ For present purposes, we highlight two reasons why a case is unobserved: deterrence or non-detection. On the one hand, good law and enforcement deters antisocial behaviour: this is hopefully its most important function, and the magnitude of deterred harm should be, but never is, included in impact evaluations. On the other hand, if a CA fails to rectify anti-competitive harm because it does not detect it, this is a foregone opportunity, or even a failure of policy. In other words, we should ask not only what are the direct observable benefits from competition enforcement, but also (i) the indirect benefits from the Law and/or the CA deters firms from behaving anti-competitively, and (ii) the costs to society from that anti-competitive behaviour which goes undetected.

Research which attempts to quantify these two magnitudes is still in its infancy, but we do have some estimates. In a rare qualitative study commissioned by the OFT, interviews were
conducted with lawyers, economists and companies involved in competition cases. From the survey of legal advisers, the research suggests that, for each merger blocked or modified by the CA, there were at least another 5 proposed mergers, that were abandoned or modified on competition grounds. This ‘deterrence multiplier’ was even higher for commercial agreements and cartels. Elsewhere in the literature, various economists have attempted to estimate the ‘detection rate’ for cartels – a typical finding is that about only 1 in 7 cartels is actually detected.

One might argue with the methods and data employed in such research, and the present authors do have severe reservations. However, even if these ‘headcount’ multipliers are accepted at face value, there remains a potentially much bigger issue - the possibility of sample selection bias. To see how this works, assume hypothetically that, for every cartel detected, there are another 5 which are deterred and a further 5 which go undetected. Can we simply assume that the magnitudes of undetected and deterred cartel harms are each 6 times greater than estimates of savings achieved from detected cases? The answer is no, because the observed sample (undeterred but detected cases) may not be a random sample of the full population of potential cases (i.e. observed and unobserved.)

So, can we improve things by quantifying the magnitudes of harm, rather than estimating the number of cases? In fact, this is daunting task because, by definition, we have no information on cases that are unobserved – because they are deterred and do not occur, or because they occur but we don’t know of their existence.

To give a flavour of our research, consider the deterrence of anti-competitive mergers. First ask the question: ‘what is likely to be the most profitable merger for the firms, but most harmful for consumers? Ceteris paribus, theory tells us that these would be mergers where 2 duopolists merge to become a single monopolist. Next, ask ‘how many such mergers do we actually observe in the real world?’ The answer is very few, and almost certainly the reason is that such mergers are rarely proposed because the firms know that they would be blocked by a CA. In other words, deterred mergers may well be far more harmful than the cases actually investigated by competition authorities.

Now consider cartels. Most theory on cartel formation assumes that potential members base their decision on whether or not to cartelise on the expected profitability of the cartel, bearing in mind the probability that it might be detected and penalised. If so, it is likely that it will be the least profitable potential cartels which will be deterred. On the other hand, and admittedly more arguably, it is the most profitable cartels which are not only undeterred but also undetected. The latter would be true, for example, if the temptation to apply for leniency was greatest for members of cartels which are least stable and least profitable.

In terms of ‘harm’, these two examples suggest that (i) the gains from deterrence may be even higher than currently thought for mergers but lower for cartels, and (ii) undetected harm from cartels is even greater than is currently thought. Our ongoing research employs a mixture of economic theory and careful econometric ‘controlled experiments to explore these issues more rigorously.
CCP Annual Conference Focuses on sanctions

Andreas Stephan, Senior Lecturer in Competition Law and Sebastian Peyer, Post Doctoral Research Fellow

The 8th Annual CCP Summer Conference was held in June 2012 on the subject of public and private sanctions in Competition Policy. The event included a number of presentations from different academic disciplines, which raised important questions about the effectiveness of the approach currently taken by competition authorities. As well as contributions from a diverse group of academics, the event also included talks by the chief economist of the Office of Fair Trading and the UK’s then Business Minister.

On the 14th -15th June, the Centre held its 8th Annual Summer Conference on the question of what public and private sanctions in competition policy actually achieve. The subject of the conference was highly topical given the recent review of the UK’s competition law enforcement regime, and the public consultation on private enforcement conducted by the Department for Business, Innovation and Skills (BIS).

The conference opened with a talk by Amelia Fletcher (Chief Economist, Office of Fair Trading), on the importance of employing the right mix of sticks and carrots in competition law enforcement. In commenting on her presentation, CCP’s Andreas Stephan broadly agreed with the importance of having a mixed approach – especially in relying on more than one type of sanction. The deterrent effect of relying only on corporate fines was drawn into question.

A political science perspective was given by Lee McGowan (Queen’s University Belfast) and Eleanor Morgan (University of Bath), focusing on the extent to which Europe’s punitive approach to competition law enforcement represents an ‘Americanisation’ of European policy. This was followed by two parallel sessions made up of presentations selected through a review process following a call for papers. It included papers by Kai Hüschelrath (ZEW), Bruce Wardhaugh (Newcastle University) and Francisco Marcos (Center for European Studies / IE Law School) on the effects of cartelisation, an American perspective of cartel control,
and the possible adverse effects of settlements and competition advocacy.

The afternoon sessions of the first day raised some interesting questions about the effectiveness of sanctions – in particular corporate fines. Christine Parker (Monash University) presented empirical evidence from Australia that suggested cartel punishment may be having an ambivalent deterrent effect, and is largely viewed by infringing firms as unfair and lacking legitimacy. Cento Veljanovski (Case Associates) presented empirical evidence from Europe to raise a number of concerns over how fines are being calculated by the European Commission and their true impact.

Discussions on many of these issues continued well into the night, over the conference dinner held at Norwich’s impressive St Andrew’s Hall and then at one of the city’s historic pubs.

The second day of the conference opened with David Ulp (University of St Andrews) talking about the welfare effects of legal uncertainty and the implications these have for the design of enforcement procedures. Angus MacCulloch (Lancaster University) and Bruce Wardhaugh (Newcastle University) then spoke about the relationship between private enforcement, criminal penalties and leniency. They identified a number of bumps in the road as enforcement continues to develop – in particular the misalignment of incentives between criminal and administrative cartel enforcement. Whereas firms beaten to immunity in a cartel case can still secure a significant discount in the fine by cooperating, there is no guarantee of leniency for individuals who have missed out on immunity from criminal prosecution.

CCP was very grateful to be given a special guest speech by Norman Lamb MP (now Minister of State for Care Services). At the time he had been responsible for announcing the review of the UK’s competition policy regime and gave the conference delegates some interesting political and policy insights into legislative reform. He also reiterated the UK Government’s commitment to stamping out anti-competitive behaviour and the belief that competition policy is of great importance to the success of the UK economy.

The first afternoon session focused on the subject of private enforcement and began with insights from the empirical research of Germany’s experience from CCP’s Sebastian Peyer’s. He pointed out that the driving force behind such actions in Germany is primarily injunctive relief rather than compensation. A panel discussion followed in which Anna Morfey (Freshfields Bruckhaus Deringer LLP), John Holmes (Which?) and Iain Mansfield (BIS), joined Sebastian to give perspectives on the issue of private enforcement from very different sides of the debate. Much of the discussion turned to the proposed 20% overcharge presumption considered in the BIS consultation document and the question of whether courts require detailed guidance as to the calculation of damages, or whether adequate mechanisms already exist in English commercial law and breach of contract.

The conference closed with three case studies. Angela Wigger (Radboud Universiteit Nijmegen) questioned some of the neoliberal principles she argued the EU has taken for granted in designing and implementing competition enforcement. She provided an alternative view and suggested that the current policy debate may be a little too narrow in its scope.

Maarten Pieter Schinkel (ACLE) provided an example from the Dutch Mortgage market where state intervention may actually have aided price coordination between competing banks. Finally, Bob Feinberg (American University) talked about the implications of State antitrust enforcement in the US for business entry and relocation.

We look forward to welcoming you to next year’s annual CCP Summer Conference, to be held on 6th - 7th June 2013 on the subject of institutions and competition policy. This will seek to explore the origins of competition institutions, their design and development, organisation and expertise, enforcement practice and their roles in consumer protection and regulation.
Private Enforcement of predation cases

Morten Hviid, Professor in Law, Director of CCP

With the number of private actions for damages increasing in the UK, we offer a word of caution about cases alleging predation. The article highlights possible misuse of such cases and explains the importance of establishing that the victim is at least an as-efficient firm as the predator.

A lot of the public discussion of private enforcement focuses on the good it can bring to enforcement of competition rules, the deterrence of violations and the compensation of those harmed by the violations. The current debate has been much less vocal when it comes to the potential adverse effects private actions can have on competition. The ability of private competition actions to soften competition is probably best illustrated through the history of private actions alleging predation brought by horizontal rivals.

Recall that simple predation involves one firm setting an unreasonably low price, usually taken to be below some measure of average or marginal cost. While this harms competitors, it clearly also benefits consumers, at least in the short run. From a public enforcement perspective, the authority has to weigh up the evidence quite carefully to ensure that it is not stifling legitimate competition which benefits consumers. In particular, the authority has to ensure that it does not fall into the trap of protecting competitors rather than competition.

From a private enforcement perspective, the relevant forum for such a case, be it a general or a specialist court, must by the same token ensure that the claimant has actually suffered an injury which competition law is designed to guard against. To use American terminology, the claimant should have suffered an antitrust injury.

There are basically two very different stories which can be told about how private actions alleging predation can have anti-competitive effects. One relates to horizontal agreements or collective dominance where the actions are used as a signal to rivals. The second relates to single firm dominance where the action is used partly to extract rent from the dominant firm and partly to reduce future competitive pressure from this firm.

The first story explains how an allegation of predation can be a facilitating practice by enabling one party to a price fixing conspiracy (or a tacit understanding of not competing) to signal its displeasure of a low price charged by rival. Here, litigation is used as a signalling device. The strategy is to initiate the case and then drop it once the rival gets the message and increases its price. Where the rival has been slow on the uptake, a settlement could be used to provide side-payments to the injured party. Note that the losers here are consumers who will face higher prices. For those who think this is entirely fantastic, the empirical analysis provided in a paper by Daniel Crane¹ suggest otherwise. While no-win-no-fee is a common way to finance antitrust actions in the US, Professor Crane finds that a surprising number of predation cases employ non-incentive based payment of the legal team. This would be consistent with an ex ante aim of settling or dropping the case. Using predation litigation as an anti-competitive signal to a rival can be a difficult strategy to counter because denying the claimant the opportunity to pursue a case interferes with very basic legal rights. What this does highlight is the importance of monitoring both litigated, settled and dropped cases, especially where these involve horizontal rivals.

The second story is one of rent extraction by a weaker firm. There is an old, long-standing, debate in industrial economics about whether firms are big (dominant) because they are bad or because they are efficient. What is certainly uncontroversial is that a persistently more efficient firm would become dominant over time. We would like firms to price at or close to their average costs to ensure that consumers get the best deal possible which is consistent with the financial survival of the firm. At that price, an inefficient firm would make a loss and would be forced to leave. That is competition for you. If the courts are not careful, however, such a firm might think it would have a case to bring alleging predation. Is this realistic? This depends entirely on what we believe about the ability of the courts to assess the conflicting claims about the costs of the dominant firm. As costs are generally estimated using some empirical method, such (statistical) measurement errors are inevitable as are legitimate disagreement among experts about these. In this case, even a dominant firm who is sure it is not pricing below its relevant measure of average costs may still be wrongfully convicted. This creates an incentive to settle or more
dangerously, where the incentive to pursue the case is high, to price safely above average costs, to the joy of inefficient rivals but to the detriment of consumers. What might provide such incentives for the claimant to pursue a case? There are at least three sources: courts with low levels of expertise in evaluating economic evidence; limited liability possibly combined with being in receivership; and generous or multiple damages.

A lot of the public discussion of private enforcement focuses on the good it can bring to enforcement of competition rules, the deterrence of violations and the compensation of those harmed by the violations. The current debate has been much less vocal when it comes to the potential adverse effects private actions can have on competition.

Keys to identifying predation in private actions. The first key element to assessing a claim of predation is that the excluded (harmed) firm is as-efficient-as or more-efficient-than the alleged predator. If this is not the case, then finding predation sets a dangerous precedent about how hard firms are allowed to compete. Competition law is about protecting competition. Finding predation where the claimant is inefficient does not serve that purpose. To establish the standing to bring a case, the claimant should be required to establish that it is an as-efficient firm.

The second key element is recoupm ent. This not only goes to the credibility of the price being set in order to predate, but also has another important role to play. The counter-factual to predation is the oligopoly price level which would emerge in the absence of the alleged predation. Consider predation against an as-or more-efficient rival. During the period of predation, the net loss to the predator is the same as the gain in consumer surplus except for three effects: the consumer gains the dead-weight-gain triangle between the counter-factual price and the average costs; the predator loses an extra small amount on the marginal sales to those who would not have purchased at a price equal to the average cost but who do purchase at the predatory price below these costs; and the part of the foregone industry profit from predation, which is lost by the target for the predation. The first two are both second order effects and can be ignored in an approximation, but the last effect is not, especially if the target is as- or more-efficient. As a first approximation, the loss which has to be recouped is less than the initial consumer gain. During the period of recoupm ent, the consumer loss exceeds the predator’s gain by the dead-weight-loss relative to the counter-factual price. This dead-weight-loss is a second order effect and hence to a first approximation the gain to the predator equals the loss to the consumers. Putting the two together, as a first approximation, if there is no recoupm ent, there is no consumer detriment. To put it differently, as a first approximation, recoupm ent is a necessary but not sufficient condition for consumer harm. Thus recoupm ent also serves as a check on whether or not the ones we really care about in the competition analysis, the consumers, are likely to be harmed.

Until recently we did not, as far as one can tell from case law, have any private predation cases in the UK. This changed with the decision by the Competition Appeals Tribunal in the Cardiff Bus case. Why are some economists worried about the decision in this case? Because it ticks all the wrong boxes. The claimant did not demonstrate that it was an as-efficient firm which ought to be the test of standing, nor did the defendant appear to challenge the standing of the claimant. The analysis of recoupm ent which the CAT inherited from the OFT decision is at least questionable as such cost analysis so often is. The OFT analysis of costs seems to suggest that prices in order not to be predatory should have been at least 72% higher than they were. In the context of the case, that would have meant that prices on bus routes where there was an entrant should have been higher than where there was no entrant. Or put differently, even the non-predatory prices did not cover the estimated costs. The claimant was in liquidation so it is not clear who would have covered the costs of the case had the claimant lost. Finally, the award of exemplary damages will raise future estimates of the amount a claimant can expect to recover if successful in a predation case. Dominant firms in the UK now have a legitimate fear of predatory cases even where they are simply engaging in hard-nosed competition. The concern is that this fear may lead not only to settlement in future cases even where the case does not have any merit but also to a softening of competition. Whether this hard lesson from US cases will be learned in the UK is something we will need to look out for.

2: It serves to corroborate any claim about the intent of the alleged predator. Most statements used to identify “intent” are basically cheap-talk without this corroborating evidence.
3: How good this and subsequent approximations are depend on the curvature of the demand function.
4: OFT in paragraph 7.206 of their decision finds that “revenue would have had to rise by 72 per cent to equal avoidable costs.”
5: Even if the cases in which exemplary damages can be awarded may be limited to cases where the dominant firm is also small, this is not absolutely settled.
How to Build Independent Regulators (and keep them that way)

Chris Hanretty, Lecturer in Politics

Most markets require some form of regulation, and most countries keep that regulation away from government departments and within independent regulatory agencies. Designing those regulators so that they are genuinely independent from government is an important task. Chris Hanretty shows how some environmental and design features matter more than we think.

As a political scientist, I have a natural sympathy for politicians. When people make negative claims about them, I feel pressed to respond. Many people claim, and much of my work is based on the premise, that politicians make consistently bad decisions when it comes to regulated markets, particularly regulated markets which were previously state monopolies.

In particular, many argue that politicians are temporally inconsistent. In the bright new dawn of an incoming government, they seek out fresh market entrants, and encourage bold new infrastructure investments. But in the jaded gallop to the polls five years later, they put the squeeze on consumer prices, holding them to levels that won’t cover any form of capital maintenance, let alone fresh investment.

Such inconsistent preferences are a problem for everyone because, if left unchecked, they create uncertainty, and uncertainty is inimical to investment. The fault, of course, lies not in the stars, but in ourselves. We voters are the ones who get sniffy about higher prices, and tend to punish governments that let prices rise.

If inconsistent preferences are such a problem, what can politicians do about them? The usual answer is that they must make some kind of credible commitment. Commitment devices are wonderful things. The most famous example is when Achilles bound himself to the mast of his ship in order to listen to the Sirens without becoming so enchanted by their music that he dashed the ship on to rocks. Less romantic commitment devices are found in many aspects of every-day life. I regularly make a credible commitment to waking up early by placing my alarm clock at some considerable distance from my bed.

For politicians, one way of ensuring a credible commitment to non-interference is to create an independent regulatory agency: an Ofcom, or an Ofgem, or the like, entrusted with promoting certain objectives that politicians (and the public) desire, and independent of politicians and thus capable of resisting subsequent attempts by politicians to go back on their word. The creation of such agencies represents a credible commitment to certain kinds of market outcome or process. The continuance of such agencies represents an on-going bind on new governments, one which they may secretly be glad of.
My work enters this happy story at two points. First, I look at the ways in which politicians can and have structured these regulatory agencies, and how they can alter their formal, or de jure independence. Second, I look at whether levels of de jure independence do really translate into actual, or de facto, independence. Is it possible for politicians to suborn the mechanisms they create to bind themselves, in the same way that many of us repeatedly hit the snooze button on our morning alarms?

The issue of designing for independence might seem straightforward. Make sure that the regulator has regular access to the funds it needs without budgets being subject to approval; make sure that ministers can’t dismiss the heads of these regulators, or that if they can they can only do so on grounds that would be assented to by all (ill health, malfeasance, non-performance of duties); and make sure that term lengths and framework agreements last long enough that regulators don’t pull their punches now in anticipation of the next set of appointments. There are, however, a number of awkward questions concerning institutional design. I’d like to take two issues in particular: appointments, and legislative scrutiny.

On appointments, many have assumed that, the more distant (in some sense) the appointments process is from the executive, the more independent the appointed body will be. On some indices of independence, regulators get scored higher if they are appointed by the legislature and the executive acting together, than if they are appointed by the legislature alone, and higher if by cabinet than by a sole minister. A model law for an independent regulatory authority would therefore have all board members nominated by the executive and confirmed by parliament.

On legislative scrutiny, it seems obvious that certain kinds of legislative scrutiny can limit independent action by regulators. It’s not pleasant to go before a parliamentary select committee and be harangued; if regulators were regularly subject to such harangues they might decide to conform to politicians’ temporally inconsistent preferences, vitiating their reason for being. But if independence requires an absence of legislative scrutiny, how are we to hold regulators accountable? How are we able to ensure that regulators are, say, taking social objectives seriously?

I wanted to check whether some of the assumptions that people had made about appointments provisions and legislative scrutiny were really sound. Together with Chistel Koop (King’s College London), I went out and collected information on the governance of a large number of regulators worldwide, asking not just about appointments but a wide range of governance provisions. Our idea was to ask a large number of questions, and boil down the answers so that we were left with a core of provisions which separated high de jure independence regulators from low de jure independence regulators.

In the process of boiling down some of those answers, we found out that some provisions just didn’t fit with the rest – including provisions on appointment and legislative scrutiny (in technical terms, they didn’t map on to a latent factor of de jure independence). In other words: I can look at how a regulator is set up in terms of the tenure of its board members, the security of its funding, the difficulty of dismissal – but statistically this tells me nothing about the method by which board members are appointed or the frequency of legislative scrutiny.

Strictly speaking, the fact that these provisions don’t map on to a latent trait doesn’t mean that they are unrelated to independence. One could still insist that these provisions matter for independence, and it’s just happenstance that they don’t fit other criteria. To give a sporting example: it’s a bit like finding that managerial salaries are unrelated to other things which make clubs good (number of passes completed, shots on target), and insisting that an expensive manager should still be brought in to improve the club’s performance.

We didn’t opt for that interpretation, and we think that this finding has happy consequences. It is good news: good because it shows that we can have our cake and eat it. We can have independent regulators that still answer to Parliament, and we in the UK can keep our current systems of appointment. Whilst there might be reasons for moving away from ministerial appointment, a need for greater independence is not one of them.
Of course, sometimes commitments can be revoked or circumvented. A second part of my research looks at what happens after the creation of regulatory agencies with a given level of de jure independence. I wanted to understand whether greater de jure independence translated into greater de facto independence. In a second paper with Christel Koop, I used a proxy for de facto independence, based on two questions: did the chief executives of these regulatory agencies leave office very frequently? And was there a link between changes in government and changes of chief executive, such that the latter frequently followed the former? The more often chief executives changed, and the more often changes of government were followed by changes of chief executive, the lower the de facto independence of the regulator.

We gathered information on chief executive turnover for a large number of European regulators across several sectors. The country-by-country and sectoral patterns were unsurprising. Regulators of network industries had the highest levels of de facto independence. Regulators of softer concerns – environment, pharmaceuticals came out worse. Regulators of financial markets occupied an intermediate position. In terms of country patterns, there was a general north-south split, with Greece, Spain and Italy coming out at the bottom.

What we really wanted to know was whether these levels of de facto independence were related to de jure independence. If they weren’t, then it would mean that all the effort put into designing these institutions was in vain. Fortunately, there was a link. Higher de jure independence did really lead to higher de facto independence. However, this was moderated by the level of the rule of law in a country. The reason Greek, Italian and Spanish regulators scored so badly was because generally the law is obeyed less in these countries than in Sweden or the UK. Within these countries, regulators with higher levels of de jure independence generally do have higher levels of de facto independence - but they start from a much lower baseline. An Italian regulator would have to be designed in an exceptionally water-tight fashion to compensate for the built-in advantage (in terms of the rule of law) that any British regulator starts with.


Institutions & Competition Policy
CCP summer conference 6-7 June 2013

Always at the heart of competition policy, institutions have come under increased scrutiny in recent years. New agencies have been created in transition states, while established authorities in Europe have undergone change and reform. Curiously, the growing consensus on the principles and practice of competition policy has not been accompanied by a convergence on organizational form or legal frameworks. Bringing together economists, historians, legal scholars and political scientists, academics and practitioners, this conference assesses the importance of institutional design, looks at the impact of institutions, and investigates processes of organizational and legal change. It addresses the following questions:

Origins and spread: What explains the original design of competition authorities in the US and in Europe? What factors led to their creation, what ideas, doctrines or ideologies underlay their responsibilities, and to what extent were principles disseminated transnationally?

Institutional design: What difference does institutional design make? How do institutions affect market outcomes? Is the one-authority model best or are there reasons to prefer a two-institutional model? What can be learned from comparing national competition policy regimes?

Organization and expertise: What form of internal organization is the most effective? Should lawyers and economists work in separate teams? What is the impact of the organization of expertise on decisions?

Enforcement: What difference do courts and legal cultures make? Is the inquisitorial or the prosecutorial model proved more effective?

Change: How best to theorise institutional change? Are generalizations about what drives change sustainable? What are the relative roles played by internal factors (ideology, party competition, the demands of regulates) and external influences (networks, such as the International Competition Network)? Is institutional reform in multi-level jurisdictions different?

Competition policy and consumer protection: Should responsibility reside in a single or in separate institutions?

Competition policy and regulation: How should competencies be divided between competition authorities and regulatory agencies? How can their work best be coordinated?

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Parallel Trade in Pharmaceuticals: are R&D investments affected?

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The diffusion of parallel traded goods has given rise to hot debates both at European and international level, calling for a more precise investigation of the effects yielded by the presence of parallel imports. In this short piece, we call attention to this topic by examining the analysis of the most recent studies conducted into parallel trade.

Parallel trade has been one of the most disputed topics in the international trade-policy ground, raising difficult questions especially in the pharmaceutical sector. Parallel trade involves issues related to intellectual property, competition and regulation.

Based on the exhaustion of intellectual property rights (IPR), parallel trade is a legal institution which allows third parties to reimport genuine IPR protected goods into a country without the authorisation of the trademark, copyright or patent owner. It represents one of the main policy dilemmas that emerges when policy makers deal with the protection of intellectual property rights, along with the application of free trade principles. Although the owner of the IPR has the exclusive right to use its own patent, or trademark, prohibiting the use by third persons. This undisputed right receives some limitations due to the principle of free movement of goods.

Once the IPR owner delivers her goods into a market (i.e. following the “first sale”, or “putting on the market” doctrine), the IPR related to these goods is assumed to be exhausted, and as a consequence the IPR holder will lose the control over the distribution of these goods. It follows that parallel import for the same good occurs from different sources, introducing some forms of arbitrage which may lead to lower prices. The question whether or not parallel trade should be permitted requires taking into account different factors, such as the peculiarities of the market where this trade is implemented, and the national demand patterns.1

The legal treatment of parallel trade differs broadly across countries, and much depends on the territorial (national, regional or international) extent of IPR exhaustion chosen by governments. In Europe, Articles 34-36 TFEU, together with the principle of regional exhaustion institute that parallel import is a legitimate means of trade, even though all European countries recognise IPR as established at the international level. Besides, any conduct oriented to prevent parallel trade is assumed to be anti-competitive and punished consequently. Indeed, the European Commission has traditionally protected parallel trade, in the belief it promotes intra-brand competition encouraging intra-state trade.

Parallel trade makes government policies interdependent and forces every government to consider the consequences of their actions on research and development investments.
Nevertheless, parallel trade remains a contentious question, which has required continuous interventions by European institutions, especially in the pharmaceutical sector. Despite the significant efforts undertaken by the European Commission, the European pharmaceutical market is still characterised by a discrete degree of heterogeneity, due to different regulatory price regimes, different health care sectors and reimbursement mechanisms. These diversities make the existence of parallel trade profitable, which despite the obvious costs has represented a growing business in Europe.

Due to the ensuing arbitrage, pharmaceutical companies try to prevent parallel imports claiming that this trade could erode their profits, undermining their incentives to innovate. In this regard, some studies argue that parallel trade, where it is permitted, has not yielded the expected results in terms of convergence in price. Indeed, parallel trade does not mean necessarily price convergence if consumers do not believe that the original drug and the parallel imported one have the same value. Moreover, recent studies conducted across European countries find that parallel trade has not resulted in significant price convergence, and apart from the difference in price between the importing and exporting countries, key determinants of parallel trade are drug policy specific variables, such as price regulation and cost-effectiveness. In addition, the interference of national governments in private markets by way of drug prices regulations is a factor causing price differences at the international level. Governments with active industrial policies having the objective of promoting innovative research and development in the pharmaceutical sector, need to take into account the effects of their decision when parallel imports are allowed.

Parallel trade makes government policies interdependent and forces every government to consider the consequences of their actions on research and development investments. Indeed, more recent studies focus on the effects of parallel imports on the incentives to invest in new research and development, reassessing the role of this trade. In the presence of parallel trade, welfare either increases or decreases depending on the drug regulations adopted by the countries and on whether dynamic effects of parallel trade are examined. The ability of government not to introduce continuous changes to its policy interventions is crucial, in particular when policy makers engage in drug price control, because their choices yield important results on the pace of innovation.

So, an undisputed answer to the initial question is very difficult to provide. In order to fully understand the welfare implications of parallel imports, governments need to be very careful not to disregard the interaction between their policy interventions, such as drug price regulation, under a regime of legal parallel trade.

2: See among others ECJ Case C-143/00 Boehringer Ingelheim GmbH, Glaxo Group Ltd and others v. Dowelhurst Ltd and Swingward Ltd; ECJ case C-112/02, Kohlpharma GmbH vs. Federal Republic of Germany, 12 September, Common Origin not prerequisite for parallel trade, Opinion; Joined Cases C-2/01 P and C-3/01 P: Bundesverband der Arzneimittel-Importeure and Commission of the European Communities v Bayer AG; Press Release No. 01/04.
3: From the 1970s, parallel trade increased significantly especially in countries with high pharmaceutical prices such as Denmark, Sweden, United Kingdom, Germany and Netherlands. Among these countries, the UK market for parallel trade is one of the largest in Europe, over 14% of the National Health Service expenditure is devoted to the parallel imports (IMS Health data).
As always the summer highlight was our annual Conference in June. With the provocative title “What do Public and Private Sanctions in Competition Policy Actually Achieve?”, the academic programme provided exciting and insightful responses to the question. We were also delighted to be joined by Norman Lamb MP, then the minister in charge of implementing the changes to the competition regime in the UK, providing us with unique insights into the future plans for legislation and enforcement in the UK. We are now looking forward to organising the next Network of Industrial Economics event in London in December, focused on the important topic of competition and healthcare.

We have been joined by some new colleagues: Ana Moniche is a new Research Associate who will be working with Catherine Waddams on consumer issues; Tong Wang has taken up a position as post-doctoral research fellow and we’ve welcomed three new members of faculty, Farasat Bokhari and Enrique Fatas (Economics) and Georg von Graevenitz (Norwich Business School). We have said farewell to one of our post-doctoral fellows, Oles Andriychuk to has joined University of Sterling as a lecturer in law, and to our communications coordinator, Leanne Denmark, who has re-joined the ranks of students.

Finally, I’m pleased to report on two new initiatives. One is our new seminar series “Competition Policy in Practice” aimed at a broader audience with talks delivered by senior practitioners in regulation and competition. The other is our second blog (www.researchatccp.wordpress.com), aimed at disseminating information about activities from within CCP.

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