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At last, a competition inquiry for energy – will it bring relief or disappointment?

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At last, a competition inquiry for energy – will it bring relief or disappointment?

Catherine Waddams, Professor in Regulation

The economic regulator proposes a reference of the energy industry to the Competition and Markets Authority, which should give a welcome respite from recent political intervention. But will the inquiry, based on competition issues, take sufficient account of other considerations in this sensitive sector to produce a conclusion which will be robust in practice? Here we look ahead to see what the CMA would consider in an inquiry.

There have been calls for many years to refer the energy market to the competition authorities, and it seems that at last the sector will be referred to the newly operational Competition and Markets Authority (CMA). Many will breathe a sigh of relief at the opportunity for a thorough review of the market, and in particular the potential for deep analysis without immediate political pressure, either directly on the market or on the regulator. Confidence in the market is at an all-time low, so it is crucial to either give it a clean bill of health, or identify the problems and explore ways of remedying them, but others may get rather less than they bargained for and be hoping for more than the CMA is likely to deliver.

Both the hope and the potential disappointment are based on the nature of the inquiry, which will focus on competition. The CMA is concerned with the competitive process and will provide in depth studies of the areas highlighted in the market assessment, jointly carried out with the OFT and Ofgem, which reported at the end of March. But this is not the stuff of political headlines, which focus on affordability and direct interventions. The government does have a new option to declare that there are issues of public interest at stake, and to require the CMA to take these into account in their inquiry. But the CMA guidance indicates that they expect such powers to be used 'rarely': it would be interesting to see them used in one of the first referrals to the new Authority. Integrating different objectives in the inquiry is likely to produce a more coherent policy trade-off than politicians superimposing their own vote catching policies later, but using a specific industry, particularly one where competitive forces are at play, to meet social objectives runs the danger of falling between two stools, with poor competitive and distributional outcomes.

The preliminary State of the Market assessment[1], undertaken by Ofgem, the OFT and the CMA, identified five potential areas of concern, namely market segmentation, tacit co-ordination, barriers to entry and expansion, vertical integration and weak consumer pressure. The task of the more substantive inquiry will be to explore whether these really do amount to an Adverse Effect on Competition (AEC).

Market segmentation, the ability to charge different prices to different consumers, arises partly because of the nature of the product, which is delivered into individual homes, and cannot be resold for safety reasons, so there is little room for direct arbitrage in the product itself. Moreover the historical background of the retail sector as a national gas monopoly and fourteen regional electricity monopolies enables the descendants of those monopolies to identify the households which are least likely to switch away, and may therefore tolerate higher prices. Indeed it is just these concerns which led the regulator to prevent the companies from charging more to such consumers than it was offering to tempt others to switch to them from the established providers in other regions. These nondiscrimination clauses were designed to prevent the segmentation of the market which the Assessment has identified as problematic, by linking the prices which companies charged to the two groups. Unfortunately two features of the market resulted in an anti-competitive effect from the nondiscrimination clauses. The first is that because the companies had most of their consumers and made most of their profits in their home regions, it made more sense for them to concentrate on their more profitable home consumers and bring prices into line by raising them outside these areas, even if it meant they recruited fewer consumers. CCP research anticipated this effect, and provided evidence after the event that this had indeed occurred[2]. Secondly, because they lobbied to be able to make temporary special offers, exempt from the nondiscrimination requirements, to enable them to continue recruiting for new customers, a huge proliferation of tariffs resulted in some consumer confusion, which dampened switching activity. The fact that companies implemented their special offers to continue recruiting those customers who did want to be active suggests that there are at least healthy pockets of competition within the sector, despite a general reduction in switching rates following the nondiscrimination clauses.

> **“Given the homogeneous nature of energy, it is difficult to see how the stable competition can flourish without some ‘grit’ in the oyster.”**

Weak customer pressure was another area which the CMA identified as a potential feature of the market which might indicate an AEC. The nondiscrimination clauses certainly played a part in reducing consumer activity, not only through the proliferation of tariffs but, more importantly, by reducing the savings which companies offered through their regular tariffs. CCP has conducted a number of consumer surveys which confirm that potential savings are the most consistent drivers of switching[3], and, unsurprisingly, consumers are less likely to bother to switch supply if there is little to gain. Untangling the extent to which weak customer pressure is a characteristic of consumers, and how far it results from supply side pressures, will be an important strand in identifying any AEC. However there has been an increase in switching to new entrants, both because they offer good deals and because of the adverse publicity and low confidence in the six large established players. This in itself may unsettle the tendency for the previous comfortable life where competition is rather lacklustre, or tacit coordination, which is a third strand of weak competition which the market assessment has identified. Many of the conditions for such coordination are present in the market (transparency of pricing, similar sized companies and stable market shares which mean few shocks to disturb the comfortable equilibrium), but if the several new entrants can continue to attract new customers, the established companies may respond by being more aggressive in their own offers. The threat is made all the more real because in response to rising prices and environmental measures, consumption has been falling steadily over the past twelve years, so that while prices rose between 2008 and 2012 (the last year for which data are available), real expenditure on household energy hardly changed at all. The big players are not only facing new competitors, they are also operating in a declining market.

However the effect of the new entrants may be limited by barriers to entry or expansion, the fourth potential area of weak competition. For example there are social and environmental duties which apply to companies who have more than a quarter of a million consumers, imposing costs of growth. This illustrates the difficulty of combining social duties with competition, since they almost inevitably become a barrier either to entry or to growth. And the need to harmonise such policies across competing suppliers may itself encourage exactly the sort of tacit coordination which the assessment identifies as problematic.

The last factor which the assessment identifies as potentially harming the competitive process is vertical integration, another area where politicians have declared their conclusion that the production processes should be separated from retail activities. The structure of the supply chain is certainly an important factor, but it requires a more in depth study to identify more precisely the barriers to the upstream market, and whether there are benefits, as well as costs, from potential integration. There may be gains to the competitive process from requiring separation, but there will almost certainly be some costs, and the balance between them requires proper investigation.

Given the political heat which the energy sector has recently generated, an in depth CMA investigation is welcome, if only to identify what a well-functioning market would look like. Given the homogeneous nature of energy, it is difficult to see how stable competition can flourish without some ‘grit’ in the oyster[4]. But the inquiry will be costly: at least two million pounds for the CMA, additional expense for the regulator, Ofgem, and high costs both of time and of paying for expert advice for companies in the sector. The inquiry can find out more about the state of competition in the market; but it cannot solve the conundrum of trying to combine the competitive process, which relies on dynamic processes and uncertain outcomes, with the demand for predictable, and low price, outcomes. The CMA will not report until after the 2015 election. The government in power at the time will need to decide whether it wants a competitive retail sector or to protect household consumers as energy prices continue to rise. Combining them is fraught with unintended consequences, as the recent history of the sector demonstrates.

1: State of the Market Assessment by the Office of Fair Trading, Ofgem and the CMA, 27th March 2014 https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment

2: See Non-discrimination Clauses in the Retail Energy Sector, by Morten Hviid and Catherine Waddams Price in The Economic Journal, 122, F236-252, 2012 for why the clauses had this effect; and Pricing in the UK Retail Energy Market, 2005-2013, by Catherine Waddams Price and Minyan Zhu, CCP research paper 13-12 for evidence that they did indeed have the expected impact, and reduced rivalry within the market.

3: Consumer Choice and Industrial Policy: a study of UK Energy Markets (by Monica Giulietti, Catherine Waddams Price and Mike Waterson), The Economic Journal, 115(506), pp 949–968, October 2005; Searching and Switching: Empirical estimates of consumer behaviour in regulated markets by Catherine Waddams Price, Catherine Webster and Minyan Zhu, CCP working paper 13-11; Consumer behaviour in the British retail electricity market by Miguel Flores and Catherine Waddams Price, CCP working paper 13-10.

4: Well-functioning markets in retail energy by Morten Hviid and Catherine Waddams, European Competition Journal, 10, 1, pages 167-179. April 2014.

Differentiated tax on differentiated products markets

Anna Rita Bennato
Post-Doctoral Research Fellow

Franco Mariuzzo
Lecturer in Econometrics

Prior to introducing a new tax or modifying an existing one, governments need to be aware of the effect yielded by their policy intervention on market outcomes. Microeconomic theory has covered many facets of the process of the generated redistribution, including how the burden of the tax is shared between firms and consumers, and has crystallized the main finding that how firms pass on a rise in a tax to consumers is not independent of the active market structure. This short piece aims at unravelling hidden aspects of the taxation process, which governments may unwittingly ignore.

The payment of a tax represents a responsible process by which taxpayers (i.e. consumers and/or firms) contribute to a government's public finance. However, the way by which taxes are imposed requires careful design, since every taxation system may alter consumer's choice, causing market inefficiencies. Looking back at history we find several examples of how inappropriate taxes have led to third best outcomes that have damaged total welfare. The most famous is the case of the windows tax introduced in England and Wales in 1696 under the reign of William III, from which we can still find today old houses with bricked up windows.

The consequences yielded by a commodity tax are quite easy to understand. The introduction of an indirect taxation, as is the VAT, yields an increase of the product price paid by a consumer, affecting the market demand. Indeed, for producers the tax is seen as a cost increment, and as such they deal with it acting mainly on the price level. In that regard, the economic literature has broadly explained that who will face the weight of the burden depends mainly on the market characteristics. In particular, the market structure plays a crucial role, where both size and the number of firms in the market, along with product characteristics, determine the final effect of an indirect commodity tax.

Since the early studies of Cournot and Wicksell we have known that under perfect competition the entire value of a tax is transferred directly on to consumers by increasing the price by the same unit amount of the tax rise. In contrast to that, under a monopoly or an imperfectly competitive market the way that the tax shifts on to consumers is never black and white, and it depends on multiple conditions among which is the elasticity of the demand. Though rare, overshifting is a possibility under monopoly, since the increment of the tax can lead to a rise of the product price higher than the tax increment.

The application of alternative systems of taxation has animated fundamental questions in public economics, underlining the effects of tax policies on the distribution of economic welfare. The microeconomic literature has studied the market outcomes of possible types of taxation with particular attention to the difference between unit tax and ad valorem (proportional) taxation, and has proven regularity conditions under which the two lead to equivalent market outcomes[1]. If introduced in a market having differentiated products, a tax policy can be used to modify consumers' behaviour[2] or to discriminate against classes of consumers and producers[3].

Although for governments a change in the taxation system may not affect their tax revenues, policy makers are urged to be aware of the consequences of their policy intervention on total welfare and the process of redistribution that it may lead to. The introduction of a new taxation, or simply a change in the level of an already existing one, has an effect not only on consumers but also on firms. For example, when tax authorities introduce an ad valorem taxation, as a proportion of the product price, in place of a specific (unit) tax in an oligopoly market, the result obtained is detrimental for firms especially if they decide their output level strategically. Despite the fall in the equilibrium price policy makers cannot expect an increment of firms' profits deriving from this intervention. Indeed, the change in the taxation system would suggest a different firm strategy, which due to the new equilibrium price leads to an expansion of its own output. However, when all other competitors act consequently, the taxation system change turns to be a harmful decision, affecting firms' profits negatively.

Results are less immediate if in the market firms supply a spectrum of product quality. When consumers have access to different product choices, the effects deriving from the introduction of a new tax depend on the consumers' love for variety. Ad valorem taxation may distort the competitive system because of a higher impact on quality products. It might be the case that as a consequence of the introduction of a new tax, firms react by reducing the quality of the products available on the market, leading to a price competition with ensuing consequences in terms of tax shifted to consumers and tax revenues. When ad valorem taxation is not per se sufficient to spur market competition, for example because of weak competition between high and low quality products, the introduction of differentiated taxation may reach the target.

During the recent recession, governments have been under pressure to preserve tax revenues. The public policy debate has centred on whether to increase VAT or the income tax. When it comes to the income tax, the temptation is to increase taxation progressively. While this may seem good at first, as it favours redistribution, it may also breach distortions in the market structure. If we think of a simplified world where high income groups purchase high quality products and low income groups low quality products, the progression of an indirect taxation can lead to interesting results. In recent work which looks at the effect of the differentiated Vehicle Registration Tax (VRT) adopted in Ireland on all new cars, we show how the introduction of this new taxation system may penalise some consumers more than others[4]. We studied the different market outcomes comparing ad valorem homogeneous taxation and differentiated taxation. Accounting for diverse degrees of differentiation we find that when the homogeneous taxation is imposed consumers who buy the inferior quality product suffer more, and for that group of individuals extreme situations are possible, that is changes in equilibrium prices are greater than the augmented value of the new tax (i.e. overshifting). If the government introduces a differentiated (by engine size and CO2 emissions) ad valorem taxation, which is higher for the superior quality products, we again observe that consumers who buy the inferior quality product are those who are affected most by this policy intervention. Testing our theoretical prediction on the Irish automobile market, our analysis shows the interdependence between differentiation in taxation and product quality, and how these characteristics interact to determine the economic incidence of taxation and the presence of overshifting on consumers.

So, even though the decision behind the introduction of a new tax is often driven mainly by political reasons, it would be important for government to evaluate their policy intervention by more carefully studying how their decisions will affect the social welfare of their citizens, having in mind the market characteristics where the new taxation system will be introduced.

This article is based on the forthcoming CCP Working Paper by Bennato AR, Mariuzzo F & Walsh PP, on "Differentiated taxation in imperfectly competitive markets".

> **Policy makers are urged to be aware of the consequences on social welfare of any changes in the taxation system.**

1: Among others see Delipalla S & Keen M, 1992, "The comparison between ad valorem and specific taxation under imperfect competition", Journal of Public Economics, 49(3), 352 – 367.

2: For one of the most recent studies see Griffith R, Nesheim L & O'Connell M, 2010, "Sin taxes in differentiated product oligopoly: an application to the butter and margarine market", Cemmap Working Paper, No. CWP37/10.

3: See, Anderson S, de Palma A & Kreider B, 2001, "Tax incidence in differentiated product oligopoly", Journal of Public Economics, 81, 173 – 192.

4: For more details see the forthcoming CCP working paper of Bennato AR, Mariuzzo F & Walsh PP, on "Differentiated taxation in imperfectly competitive markets".

The processes for regulatory appeals: One size does not fit all

Despoina Mantzari, Post-Doctoral Research Fellow

Appeals are fundamental to an effective regulatory regime. Given the broad discretionary powers that utility regulators enjoy, appeals provide a vital safeguard against unfair or wrongful decisions. Nonetheless, a common critique of the UK regulatory appeals' framework is that it is unnecessarily complex and fragmented and that greater uniformity and consistency in the routes of appeal and appeal bodies should be achieved. Such proposals however, overlook the differences between each of the sectors in terms of history, industry structure, the propensity to appeal the regulator's decisions and the requirements of EU law and of the ECHR. Those features support retaining rather than reforming the existing regime. Nonetheless, some improvements could still be made at the margins.

The UK is unparalleled amongst the EU Member States for its complex institutional architecture governing appeals against utility regulators' decisions (i.e. OFCOM, OFGEM, OFWAT). Not only do appeal routes vary depending on the nature of the issue involved, but they also differ significantly for each of the regulated sectors. Furthermore, a number of appeal bodies with dissimilar expertise in regulatory matters (e.g. the CMA, the specialist CAT, the High Court) and entrusted with varying standards of review (e.g. judicial review, statutory review and statutory appeal) have been involved over time in scrutinising regulatory decisions. This fragmented structure can be explained historically. Because there were no precedents for the regulators to work with in the wake of the utilities privatisation, the whole policy process developed in an incremental fashion. Furthermore, the absence of any tradition of administrative litigation in the UK or any kind of codification of administrative procedures, such as the US Administrative Procedure Act, impeded the development of a uniform procedural framework governing the appeal processes across the regulated sectors. Finally, during the last decade, the complexity has increased because of the uncertainty surrounding the requirements of the ECHR (e.g. proportionality) and EU law in this context.

Given the above, a recurring theme in the policy debate on regulatory appeals revolves around the necessity of improving consistency in the routes of appeal across sectors with the aim of minimising the perceived complexity and enhancing the overall effectiveness of the regime. This short article asks whether the UK should retain the existing fragmented structure or whether the overriding consideration should be to achieve uniformity in the appeals processes and appeal bodies. It will be shown that there are strong reasons for retaining the existing arrangements, and that those are primarily related to differences between each of the sectors in terms of history, industry structure, the propensity to appeal the regulator's decisions and the requirements of EU law and of the ECHR. Nonetheless, some improvements could still be made at the margins, which will be briefly discussed.

> “Should the UK retain the existing fragmented structure or achieve uniformity in the appeals processes and appeal bodies?”

The original regime for regulatory appeals

The original legislation establishing the utility regulators made little provision for appeals. Instead, their decisions could only be challenged by way of judicial review before the generalist High Court and on limited grounds (i.e. illegality, irrationality or procedural impropriety). The only major exception to judicial review existed in the case of licence modifications and price control decisions, whereby the licensees were able to veto any modifications that the regulator proposed by triggering a reference to the Monopolies and Mergers Commission; a peculiar form of appeal both in terms of its wide scope under the 'public interest test' and narrow availability.

The main features of the existing regulatory appeals regime

The aforementioned basic structure adopted for the review of regulatory decisions was challenged by two significant legislative developments in the late 1990s. First, the introduction of statutory rights of appeal gradually led to the marginalisation of judicial review as the primary means to challenge regulatory decisions[2]. Second, the establishment of the specialist CAT largely replaced the High Court as the primary venue for hearing such challenges.

The CAT enjoys both statutory review (similar to common law judicial review) and statutory appeal jurisdiction (where it engages with the factual merits of the case) whereas the recruitment of 'lay members' enables it to perform a 'profound and rigorous scrutiny' of the regulators'

Appeal Bodies and Standards of Review

Type of Decision	Appeal Bodies	Standard of Review
Licence modifications	CC/High Court	Merits/JR
Price controls	CC (telecoms CAT and CC)/CAT	Merits (telecoms JR at CAT)
Energy code modification appeals	CC/High Court	Merits/JR
Licence condition enforcement - All except TCLC - TCLC	 High Court Cat	 JR Merits
Competition Act - infringement/interim measures - penalty decisions	CAT	Merits

economic and technical analysis. The majority of OFCOM's policy decisions and regulatory judgments under the Communications Act 2003 are subject to an appeal on the merits. Those represent the largest number of regulatory appeals before the Tribunal. This is owing to the following two factors: first, to the progress made in the liberalisation of the telecommunications market compared to the other regulated sectors; and second, to the regulator's obligation to review the vast number of regulated product markets every three years under the EU Common Regulatory Framework for electronic communications (CRF). The need for a merits based review was affirmed when implementing into UK legislation the CRF requirement that Member States must provide an appeals mechanism that takes due account of the merits of the case; however, some commentators as well as the Court of Appeal have insisted on the hybrid nature of the appeal. Appeals from 'appealable decisions' of the CMA and sectoral regulators under the Competition Act 1998 are also reviewed on the merits. Such appeal rights are exercisable by anyone with a sufficient interest (e.g. consumer group, competitor). In such cases, the CAT's powers extend to substituting the decision for that of the regulator. Nonetheless, the Court of Appeal has placed certain limits on the Tribunal's far-reaching powers in scrutinising the agencies' decisions. However, the CAT's limited jurisdiction in relation to appeals against penalties imposed on regulated companies is striking, as these are heard by the High Court on grounds similar to those of judicial review. It can be argued that a full merits review of these cases before the CAT would enhance consistency in the enforcement appeals and ensure greater compliance with Article 6 ECHR.

Crucially, both the High Court and the CAT are insulated from the review of financially significant regulatory decisions, such as price control decisions and licence modifications. Such complex cases are decided in the first instance by the CMA, which has access to a broad pool of investigators, including Utilities Panel members. However, significant differences exist in the CMA's decision-making authority between the energy and telecommunications sectors. This is mainly attributed to the implementation of the EU Third Energy Package which strengthened affected parties' rights to appeal against regulatory decisions, and transformed the CMA into a fully fledged appeal body charged with merits-based review of OFGEM's decisions.

Unlike the process in the energy sector, in appeals against price control decisions in the communications sector, the CMA is required to follow specific directions given by the CAT. Upon the Tribunal's determination that a particular appeal raises a specified price control matter, this must be referred to the CMA for determination 'on the merits'. In contrast to the energy sector, participation in the CMA proceedings is limited to the parties to the case, the appellant, the regulator and any interveners who are admitted by the CAT. Given that the CMA has both the resources and the expertise to deal swiftly with price control matters, it is suggested that price control appeals should be simplified so that they go directly to the CMA.

In sum, the distinctiveness of the regulatory appeals processes reflects the piecemeal and evolutionary transformation of the British regulatory state. The alleged inconsistencies in the routes of appeal and appeal bodies across sectors are supported by genuine policy and legal considerations and thus do not justify significant procedural and institutional reforms, other than the targeted adjustments discussed above. Perhaps, it is high time that the policy debate started shifting towards the reform of the regulatory decision-making process.

1: See e.g. Department of Business, Innovation and Skills (Bis) 2013, 'Streamlining Regulatory and Competition Appeals-Consultation on Options for Reform' ; House of Lords Select Committee on the Constitution (2004), The Regulatory State: Ensuring its Accountability, The Government's Response, HL 150, 2003-4.

2: See e.g. the Telecommunications (Appeals) Regulation 1999.

3: See Hutchison 3G v Ofcom [2008] CAT 11; Vodafone Ltd v OFCOM, [2008] CAT 22; TalkTalk Telecom Group Plc v Ofcom [2012] CAT 1.

4: See K Lasok, 2005, 'Appeals under the New Regulatory Framework in the Electronic Communications Sector' European Business Law Review 16(4), 787; T-Mobile (UK) Ltd and Telefónica O2 UK Ltd v Office of Communications [2008] EWCA Civ 1373 (per Jacob LJ).

5: With the exception of appeals against penalties for breach of the transmission constraint licence condition under the Energy Act 2010 which are heard by the CAT.

6: See e.g. CC02/07, E.ON UK Plc and GEMA and British Gas Trading Limited-Decision and Order of the Competition Commission (10 July 2007).

Do small business customers need more buyer protection?

Amelia Fletcher, Professor of Competition Policy
Antonio Karatzas, Research Associate
Antje Kreutzmann-Gallasch, Research Associate

When individual consumers purchase goods and services, they enjoy certain protections that are not available to business customers. This reflects a view that businesses are able to look after themselves. But is this really true of small business customers, or do they face similar problems to individual consumers? If the latter, should they be afforded greater buyer protection? Recent CCP research suggests that change is needed.

When large businesses buy goods and services, they are broadly considered capable of looking after themselves. They have sophisticated procurement departments. Their large scale gives them good incentives to buy efficiently and strong bargaining power vis-à-vis suppliers. There is not therefore thought to be any need for substantial buyer protection. The principle of caveat emptor or 'buyer beware' is seen as ample.

The situation is very different for individual consumers. There are concerns that they may not have the right information, or the ability to assess that information, to make effective purchasing choices. They have limited bargaining power, and suppliers may be able to distort their purchasing decisions through misleading sales practices or by hiding unfair terms in the small print of their contracts. They may face switching costs that restrict their choices.

Reflecting these concerns, there are a variety of provisions in place to help protect individual consumers, both under general consumer law and also within sector-specific regulations. Not only is this important for consumers, but it is also important for competitive markets. Markets will work well, and deliver benefits to consumers and the wider economy, only if the demand-side of the market works well. That is, if consumers make good purchasing decisions.

So far, so sensible! But what then should be the policy position for smaller businesses when acting as consumers? Should they receive only the limited protections available for large business customers? Or do they deserve protections more akin to those available for individual consumers? After all, at their very smallest, such businesses take the form of sole traders, who are not in an obviously different position from individual consumers.

Recent research by CCP, commissioned by the Federation of Small Businesses, examines this question. It first looks at how effective small businesses are in making purchasing decisions. It then reviews what protections are provided for smaller business customers in practice, before concluding with some recommendations for change.

How effective are small businesses in making purchasing decisions?

Intuitively, there are a number of reasons why we might expect the purchasing decisions of small businesses to be more akin to individual consumers than to larger businesses. Small businesses typically lack specialist procurement expertise (excepting for purchases directly linked to their core trade). They often buy relatively little, and therefore have poor bargaining power and low benefits from expending time and effort making purchasing decisions. At the same time they may have high opportunity costs of such time and effort.

The empirical evidence on this point is surprisingly limited and mainly comprises surveys carried out in the regulated sectors. However, to the extent that it exists, the evidence supports this intuitive view. In general terms, relative to larger business customers, smaller businesses are:

- less likely to receive good advice or clear information
- more likely to be unclear or confused about their options
- more likely to feel they are not getting a good deal but nevertheless less likely to switch
- more likely to blame their failure to switch on the fact that the switching process is too complex and time-consuming.

But if smaller business customers behave more like individual consumers than like larger business customers, this raises an obvious question: Are they getting a level of buyer protection that reflects this?

Small business customers and general consumer law

Under general consumer law, which applies across all markets, the answer is clearly no. There is some limited

> Do small business owners deserve protection akin to those available to individual consumers?

protection for business customers generally, but there is nothing extra for smaller business customers than larger ones. As such, smaller business customers get substantially less protection than individual customers. For example, they don't receive the same protection against misleading sales practices or unfair hidden terms in contracts.

Much of this core consumer legislation emanates from the EU. So is this failure to protect smaller business customers down to decisions made in Brussels rather than the UK? Actually, no. The two main recent directives in this area (the Unfair Commercial Practices Directive, 2005, and the Consumer Rights Directive, 2011) explicitly allow for domestic legislation to extend provisions to smaller businesses. Moreover, while the latter directive is still being implemented, the former directive has in fact been extended to smaller businesses in Germany, Austria, France, Sweden and recently Italy, albeit to varying degrees. There has, however, been no such extension in the UK.

The issue has not been completely neglected, however. The law on unfair contract terms was the subject of a 2005 report by the joint Law Commissions of England and Scotland. This report in fact recommended that the legal protections available to individual consumers against unfair contract terms should be extended to micro-businesses, a recommendation that was accepted by the then Minister Ian McCartney. However, implementation was put on hold pending the development of the Consumer Rights Directive in the EU and the UK now looks unlikely to take forward this recommendation in enacting the new Consumer Rights Act.

Small business customers and the regulated sectors

The situation for small business customers is rather more positive within the regulated sectors. This is important because these sectors provide core inputs for many small businesses. Indeed, much of the available evidence on problems faced by small business customers comes from these sectors. This includes not only the survey evidence described in our report, but also a number of more specific instances of harm, such as the mis-selling of Interest Rate Hedging Products (IRHP) to Small and Medium Enterprises which is currently subject to a major redress exercise following action by the Financial Conduct Authority (FCA).

That said, while the picture is broadly positive, it is also mixed.

- In telecoms, Ofcom follows a broadly consistent policy of extending all consumer protection provisions to micro businesses. This reflects (although it is not strictly dictated by) the wording in the 2003 Communications Act.
- In energy, Ofgem considers each element of consumer

protection separately, on the basis that any extension of regulatory protection should be proportionate and justified by the evidence. However, it has given considerable focus to this area in recent years, and has increased the protections afforded to micro businesses as consumers (as well as broadening its definition of micro businesses).
- In financial services the picture is complex, with consumer protection provisions extended to business customers in some areas, but not others. This broadly reflects underlying legislation, as opposed to policy choices by the regulators. It is noteworthy that the FCA has, where able, been pro-active in protecting business customers, such as in the aforementioned IRHP case.
- In water, the England and Wales regulator Ofwat has no special provisions for smaller business customers. In the past, such customers have been unable to switch water and sewerage supplies, and thus consumer protection has arguably been of less relevance. This will change following the enactment of the current 2013 Water Bill, and Ofwat is currently revisiting this issue.

Recommendations

Any extension of regulation potentially creates costs for suppliers. As such, it should only be done if there are sufficient benefits to outweigh such costs.

It was beyond the scope of CCP's research to carry out a full cost-benefit analysis of extending the any particular area of law to small business customers. It is noteworthy, however, that no such analysis seems to have been done in the context of designing legislation to date. While the sectoral regulators have done more substantive analysis in this area, their hands are often tied by the legislation under which they act.

Given this, we recommend the following.

- When drafting consumer legislation, and also legislation for the regulated sectors, Government (UK and EU) should give active consideration to extending provisions to micro businesses, based on an analysis of all relevant evidence.
- Regulators should consider further extending sector-specific consumer protections to micro businesses (or further), where they are able to do so.
- Where not already available, regulators should consider requiring utility suppliers to publish their standard tariffs for smaller business customers. (This appears to be an issue in energy, in particular).
- Regulators should regularly review whether businesses with low usage get a worse deal than domestic consumers with equivalent consumption. If so, this may reflect that the market is not working well which may in turn reflect consumer protection problems.

This article is based on Fletcher, A, Karatzas, A and Kreutzmann-Gallasch, A., report for the Federation of Small Businesses (FSB), 'Small Businesses As Consumers: Are They Sufficiently Well Protected?' http://www.fsb.org.uk/policy/assets/fsb%20project_small_businesses_as-consumers.pdf

Book Review:
Behavioural Economics in Competition and Consumer Policy.

Judith Mehta, Editor and CCP Research Coordinator.

CCP's book, Behavioural Economics in Competition and Consumer Policy, was launched to an audience of policy-makers at the Competition Commission in London on November 27th 2013, and has been eliciting some favourable comments:

'Overall, the combination of the university's strengths in competition, regulation and behavioural economics is great to see in this policy area, and an excellent example of the relevance of academic research to policy formation. In Ireland, the proposed merger of the National Consumer Agency with the Competition Authority is proceeding and I think either body would be interested in this publication.' Dr. Pat McCloughan, PMCA Economic Consulting

'… the book provided useful food for thought.' Anne Bolster, Competition and Markets Authority (CMA)

'The approachable and practical nature of the book is just another proof that the CCP's work can not only nurture innovative scholarship but also communicate that scholarship across the academic iron curtain to a wider audience of policy makers.' Sean F. Ennis, OECD

'I have found it very useful as a reference and to recommend to others.' Martin Cave, Competition and Markets Authority (CMA)

'… very clearly written and a valuable reference on behavioural economics, which as an issue does crop up in our work from time to time.' Peter Langham, National Audit Office

Written by researchers from economics, law, politics and business management, the book brings together the insights they have acquired – through surveys, experiments, theoretical work and market case studies – on the implications of behavioural economics for competition and consumer policy. The central issue is whether and how policy-makers can intervene to improve on market outcomes when some, but not all consumers, are characterised by biased beliefs and/or limited cognitive skills, attention and willpower. It turns out that the design of remedies is far from straightforward in the presence of these 'behavioural' consumers and that, under some conditions, intervention can do more harm than good. CCP's book goes some way to determining exactly what those conditions are. It points to what has been learnt about the behavioural consumer in theory and through the experience of a number of behavioural remedies, and it projects forwards in discussing where a new body of literature is taking us with respect to policy-making.

An e-version of the book can be downloaded at no charge from the following site: http://competitionpolicy.ac.uk/ccpbook

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Day One

Overview: Legal framework and key economic concepts

Morten Hviid, CCP & Law School, University of East Anglia (UEA)

Market definition and market power

David Parker, Frontier Economics

Mergers: Unilateral effects

Kate Collyer, Competition and Markets Authority (CMA)

Horizontal agreements and coordinated effects mergers

James Kavanagh, Oxera

Day Two

Exclusionary abuse of dominance

Matthew Bennett, Charles River Associates

Exploitative abuse of dominance

Kirsten Edwards-Warren, Compass Lexecon

Vertical restraints

Amelia Fletcher, CCP & Norwich Business School, UEA

Mergers: Non-horizontal effects and minority stakes

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What happens when collusive firms try to avoid antitrust punishment?

Subhasish M. Chowdhury, Senior Lecturer in Economics
Frederick Wandschneider, PhD Student in Economics

Experimental research run by the CCP shows that when colluding firms can invest to avoid antitrust punishment, occurrences of infringement and collusive market prices go up, and cartels seem to become more stable.

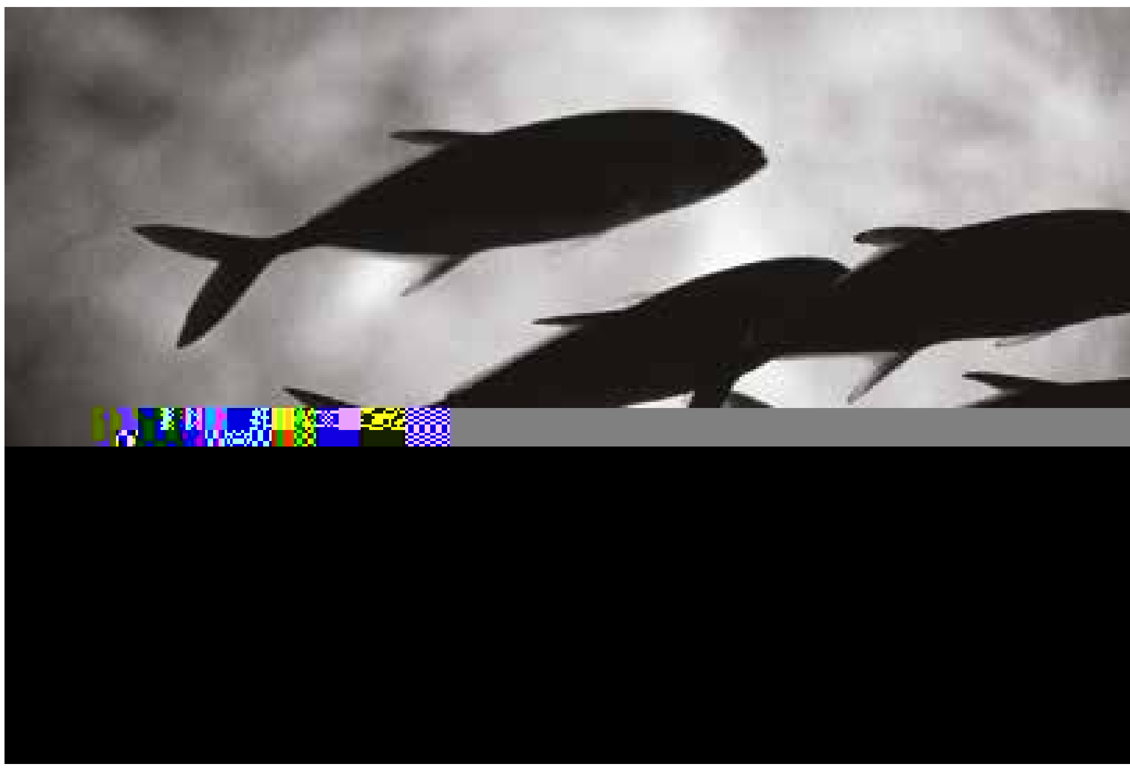
It is well established that firms that deliberately infringe competition law often use a multitude of avoidance procedures to reduce the likelihood of detection of their infringement acts or, in case of detection, to reduce their potential antitrust fines.

Examples of such avoidance activities include consulting with antitrust experts to litigate for the reduction of any potential fines, the destroying or covering up of incriminating evidence, lobbying for favourable policy guidelines, and the restructuring of a firm's finance to qualify for an inability-to-pay reduction. Such avoidance activities have particular implications for the design of public enforcement policies, as they affect both the deterrence and the social cost analysis. From a welfare perspective, avoidance expenditure cause an additional cost to firms and are socially wasteful as labour and capital is diverted from more productive activities. Moreover, all else equal, avoidance activities reduce the level of deterrence as expected fines decrease. Overall, after accounting for the need to counter this effect by increasing enforcement expenditures as well as for the wasteful avoidance costs, it is not generally possible to say if the standard results in the optimal antitrust enforcement, obtained without including the possibility for avoidance, still remain valid.

To date it is unclear how the possibility of avoidance expenditures may affect the choice to participate and engage in a (illegal) cartel. The purpose of this study is to gain behavioural insights into firms' avoidance activities in a controlled laboratory environment.[1] A key advantage of using an experimental methodology is the lack of the sample-selection bias inherent to any empirical study on antitrust infringements, which by their nature need to rely on the sample of detected and successfully prosecuted cartels. The laboratory avoids this limitation and offers full control and transparency over all aspects of the firms' decision, in particular the real world unobservable avoidance activities.

Similar to an earlier experimental study run by the CCP,[2] we employ the experimental methodology in which human subjects play the roles of economic agents and are paid according to their performance. Experimental methodology allows one to observe the effect of a policy induced change in any of the key parameters in ways that are not possible outside of the controlled environment of the laboratory. Applications of this method can be found in a recent book.[3] In the current experiment, each subject plays the role of a firm, competing in a market over prices. The firm charging the lowest price captures the whole market, and the process is repeated. Firms can form a non-binding price cartel; however such collusion is deemed illegal and if detected, can result in financial penalties. We consider two cases: one in which paying for avoidance activities - that will reduce the possible antitrust fine - is possible, and another in which it is not. Additionally in two further cases, similar to the ones described above, we allow subjects also to self-report the existence of a price cartel in return for a reduction in fines. This makes it possible to explore the robustness of our findings in the presence of an important policy, Leniency, which is unique to antitrust enforcement. The price range in all of the cases was from 90 to 102.

We are interested in the following specific questions. First, whether the possibility to avoid result in higher level of infringement - as suggested in an academic study.[4] We are



also interested to see the effects of the leniency programme, as a leniency programme may change the results. Finally, we seek to find if the stability of the cartels are affected in any way when the avoidance option is available.

The data retrieved from this experiment reaffirms the conventional wisdom that firms opt to infringe competition law more when they can choose to avoid possible fines. However, this effect melts down when a leniency program is in place. Firms use this avoidance option as an insurance against the possible fine – as risk-averse firms, and firms that previously faced antitrust fines opt for avoidance more. Surprisingly, however, cartels are more unstable when an avoidance option exists. This is because firms deviate more when they have already opted for avoiding the fine against a cost.

The diagram below shows the percentage of firms opting for collusion in each of the cases. It can be observed that with or without avoidance, leniency works well, in the sense that the percentage of firms who try to collude are less in the case of leniency. More interesting though, is the observation that in each of the cases the option to avoid increases the percentage. This indicates that when firms have the option to avoid the possible fine that can be levied upon them, they opt for infringing the law more.

Of course, this result is a matter of concern for the competition authorities as well as for the general consumers. As avoidance activities are not uncommon, this result also indicates that the estimated occurrences of cartels might be less than what it actually is. A more accurate measure of the damage caused in the market due to the avoidance activity, however, would be the price charged in the colluding markets with and without the avoidance options. The table below shows exactly that.

When firms have the option to avoid the possible fine... they opt for infringing the law more.

In this experimental setting, price could vary from 90 to 102. A pure competition could bring the market price down to 90. In this table we concentrate only on the cases when cartels were formed. We can see that the price charged by the cartels go up almost 2 points when avoidance acts were possible compared to when it was not. This gives us an idea about how avoidance acts translates into higher prices in a market.

Having observed that avoidance activities may result in both higher levels of cartel formation as well as higher prices, our final area of interest is to understand whether avoidance activities have any effect on the stability of cartels. The table below shows the percentage of cartel members who deviate from the agreed price and charge a lower price to capture the whole market. It can be seen that deviation is less both with and without leniency when avoidance is possible.

Finally, we check how often colluding firms report about their cartels when a leniency program exists. We observe that 54.36% of cartels get reported when there is no avoidance option, but this comes down to 36.63% when an avoidance option is available.

Overall, this study finds strong effects of avoidance activities in the formation, performance and stability of cartels. As collusion is already socially costly, these results also show how additional costs might incur upon the society due to avoidance. On a positive note, however, this study indicates that it might be difficult to detect and prosecute cartels, but it is easy to observe avoidance acts. Hence, if the policy focus can be brought upon the avoidance activities, then it might be possible to reduce the possible (negative) effects of cartels in a market.

1: Chowdhury, SM & Wandschneider, F, 2014, 'An Experimental Analysis of Optimal Antitrust Enforcement under Avoidance', CCP Research, Mimeo

2: Chowdhury, SM & Wandschneider, F, 2013, 'Antitrust and the Beckerian Proposition: the Effects of Investigation and Fines on Cartels', CCP Working paper 13-9

3: Hinloopen, J, & Normann, H (Eds), 2009, Experiments and Competition Policies: Cambridge University Press

4: Jensen, S, Kvaloy, O, Olsen, TE, & Soergard, L, 2013, 'When tougher punishment leads to a more severe crime: an application to antitrust enforcement', NHH Dept. of Economics Discussion Paper No. 04

The use of general merger control in English healthcare

Mary Guy, PhD Student in Law

Following the Health and Social Care Act 2012 (HSCA 2012), what are the limits of general merger control within the English secondary healthcare sector?

It is not particularly controversial to suggest that general merger control is limited regarding hospital mergers.[1] The complexities and political sensitivities in healthcare suggest a need for mergers to generate both economic and, clinical or non-clinical, patient benefits.

The situation in England[2] is compounded by both the traditional distinction between Private Healthcare (PH) and the NHS, and the ongoing evolution of competition in healthcare, including increased use of general merger control. This note suggests that, following the HSCA 2012, three derived assessment procedures may be applied across English healthcare in addition to general merger control.

This raises the question of what the limits of general merger control are.

Pre-HSCA 2012

Prior to 1 April 2013, the distinction between the NHS and PH sectors was reflected in two discrete procedures.

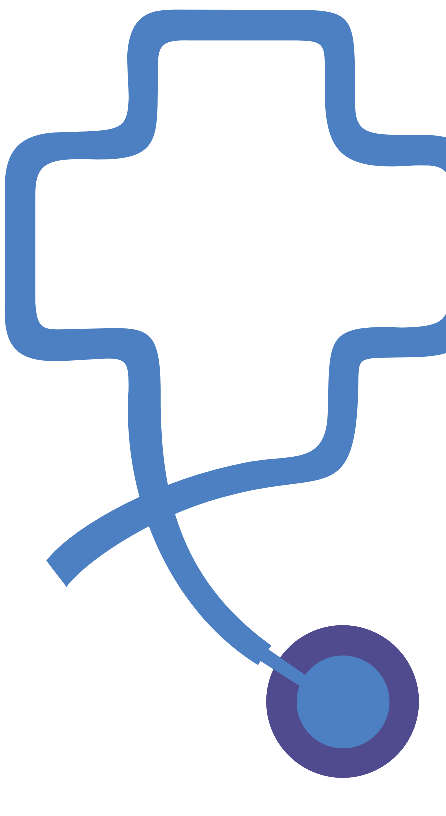
Procedure 1 – the NHS Cooperation and Competition Panel (NHS CCP) merger guidelines:
From January 2009, mergers and related transactions between NHS Trusts and/or NHS Foundation Trusts (FTs)[3] were subject to review by the NHS CCP, which advised the Secretary of State for Health or Monitor (as FT regulator) as final decision maker. The substantive test established firstly whether a merger reduced sufficient competition and patient choice, and secondly whether any material benefits to patients and taxpayers offset this.

It is to be noted that the NHS CCP test[4] still exists, albeit with the apparent sole purpose of reviewing mergers arranged within the broader policy context requiring the majority of NHS trusts to become NHS FTs by April 2014.[5]

Procedure 2 – the Enterprise Act 2002 (EA02) general merger provisions:
The CMA has exclusive competence regarding PH mergers, and has applied the two-stage 'significant lessening of competition' (SLC) test based on a 'relevant merger situation' and subject to identification of 'relevant customer benefits' exceptions.[6] The test covers both private hospital operators and Private Patient Units (PPUs) operating within NHS facilities, as both are considered 'enterprises'.

Post-HSCA 2012:

The HSCA 2012 has led to two notable changes to merger control as applied in English healthcare. The most controversial change thus far is that the CMA now applies the EA02 test to NHS FT[7] mergers. However, the HSCA 2012 also removed the cap on income which NHS hospitals can make from private patients[8]. Concerns that this will lead to an expansion of PPUs and distort the PH market has led the CMA to propose a new 'competition test' similar to merger control.[9]



These changes suggest that it is now possible to speak of a third and fourth procedure.

Procedure 3 – EA02 general merger provisions as applied to NHS FTs:
In essence, this reflects Procedure 2, albeit with an additional but potentially significant advisory role for Monitor to identify 'relevant customer benefits'.

Procedure 4 – a new 'competition test' for PPU transactions:
This new one-stage test allows the CMA to conduct a case-by-case assessment where weak competitive constraints may preclude smaller or new entrant PH operators from entering into PPU transactions with NHS FTs. Although

PPUs have not featured prominently in merger cases to date, there has been support for this proposed test among PH operators.[10] This arguably suggests that the CMA is right to anticipate a potential need to review transactions which may ultimately prove distortive but not amount to a 'relevant merger situation', for example the leasing of space or using an NHS Trust name in the PH operator's branding and promotion of facilities.[11]

Some limitations of general merger control in English healthcare

In light of the four procedures, the limitations of general merger control can be described as jurisdictional, substantive and institutional, with inevitable overlaps between the three.

Jurisdictional limitations

These are arguably most evident in the new competition test for PPU transactions, which perhaps represent a first modification of the EA02 test for the PH sector. However, there is a need to balance a need to review certain transactions with the perception of assessment criteria, which can form a barrier to change, as has been noted within the NHS regarding competition rules.[12]

Substantive limitations

The primarily economic focus of general merger control is widely recognised as a limitation in that scope to consider patient benefits can only be acknowledged in the context of the 'relevant customer benefits' exception. However, patient insensitivity to price and defining quality make this problematic.

This has led to Monitor and the CMA emphasizing the significance of patient benefits[13] and to a call for a separate, non-statutory, public interest test to balance all costs and benefits flowing from NHS mergers.[14] This call represents an interesting link between substantive and institutional limitations as the CMA is proposed as the best decision-maker in light of its competition expertise[15], although categories of 'public interest' are associated with the Secretary of State.

Institutional limitations

In addition to the above example, institutional limitations arising from the CMA's exclusive competence can be seen in the roles of the Secretary of State and Monitor.

The Secretary of State for Health's role and influence within the EA02 test is significantly reduced, which is arguably undesirable in a sector as politically sensitive as healthcare. To remedy this, it has been suggested that public healthcare be included as a 'specified consideration' under s.58 EA02[16], effectively exempting it on public interest grounds. However, no governing party in recent times has taken this step.

The HSCA 2012 introduced only an advisory role for Monitor (in contrast to concurrent powers regarding competition law). This has the potential for sector-specific advice to be side-lined, although limited experience thus far[17] suggests close cooperation between Monitor and the CMA.

The ongoing and perhaps curious reluctance to consider PH and the NHS as parts of a wider 'healthcare' sector sets England very much apart and complicates this inherently complex sector with various oversight bodies and tests. In this light, increasing use of general merger control can be understood as an attempt to bring a certain degree of uniformity and set a specific standard, as well as contributing to a competitive environment. However, it is clear that the limits of general merger control are substantial, apparently undermining the possibility of a 'one size fits all' solution for English healthcare.

1: For example, following various controversial hospital merger decisions in the Netherlands, modifications to merger assessment have recently culminated in the introduction of a statutory "healthcare-specific" merger test.

2: Although the CC's report applies to the UK, the focus here on England is deliberate as the relationship between the NHS and PH varies across the UK and the HSCA 2012 applies to the English healthcare sector only.

3: Bodies (typically including hospitals) with varying degrees of autonomy from central government.

4: The NHS CCP's role has been subsumed by Monitor, which reports to the new NHS Trust Development Authority (NHS TDA), thus reducing the Secretary of State's input further.

5: As acknowledged in NHS CCP comments in merger cases. See, for example, CCP, 'Merger of Royal Free London NHS FT with Barnet and Chase Farm Hospitals NHS Trust' 13 August 2013. http://www.monitor.gov.uk/sites/default/files/publications/Barnet%20Chase%20Farm%20Royal%20Free%20report%20FINAL%20EXCISED.pdf

6: Defined under s.30(1)(a) EA02 as "lower prices, higher quality or greater choice of goods or services […]".

7: NHS FTs are bodies (typically hospitals) which have achieved a certain degree of autonomy from central government and are regarded essentially as commercial entities and subject to authorisation by Monitor. This is in contrast to NHS Trusts, which are less independent and remain under the ultimate oversight of the Secretary of State via the NHS TDA.

8: S.165(1)(b) HSCA 2012.

9: The SLC test has been considered more suitable than a "bright line" test, and Monitor's remit deemed too restrictive as regards oversight. Competition and Markets Authority, 'Private Healthcare Market Investigation' Final Report, 2 April 2014. CMA 25. Paras 11.316, 11.328.

10: Mainly among Private Medical Insurers (PMIs). Ibid, paras 11.255-11.294,

11: OFT, Anticipated Lease by HCA International Limited of Premises from Guy's and St Thomas' NHS Foundation Trust, Case ME/5641/12, 7 November 2012.

12: P Corrigan, A Taylor, 'The CMA can improve the NHS merger regime: here's how', Health Service Journal, 26 March 2014.

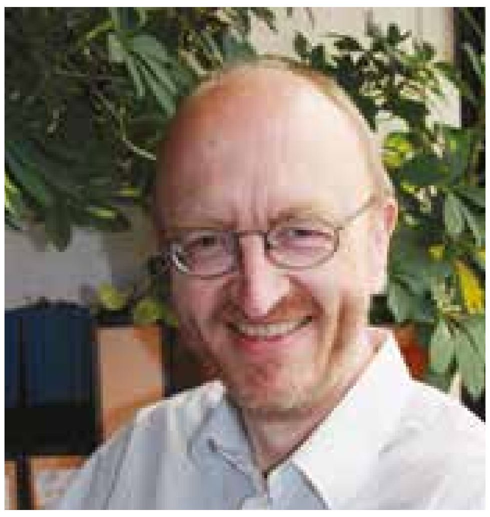
13: Monitor, CMA, 'Ensuring that Patients' Interests are at the heart of assessing Public Hospital Mergers', Joint Statement from the Office of Fair Trading, Competition Commission and Monitor, 17 October 2013. http://www.monitor.gov.uk/sites/default/files/publications/131017_oft_cc_monitor_merger_statement_final.pdf

14: P Corrigan, A Taylor [n12].

15: Ibid.

16: K Desai, 'Public hospital mergers: a case for broader considerations than competition law?', E.C.L.R. 2013, 34(12), 646-653.

17: Most notably in the Royal Bournemouth and Christchurch Hospitals NHS FT and Poole Hospital NHS FT merger case.



Director's Letter: News from CCP

Morten Hviid

Our 10th Annual Conference this summer will focus on 'Problem Markets'. These markets, which appear not to be working well for the consumer, can sometimes seem to be a bit 'too hot' for regulators to handle, and no one is quite sure why or what, if anything, could be done. This conference will examine the various possible explanations of these problems, as well as considering the potential for intervention which might help. As in the past, we have a strong line-up of speakers and we are looking forward to two days of interesting talks and exciting debates.

Since the last Research Bulletin, our new book 'Behavioural Economics in Competition and Consumer Policy' has been published. A successful launch event was hosted at the Competition Commission in November 2013. The book has provided us with an opportunity to share the insights we have acquired over the past years in an accessible format and with a wide audience in mind. It is available electronically at http://competitionpolicy.ac.uk/ccpbook.

As always, there are changes to the team at CCP. We welcome our new Centre Manager Laurence Wild and Administrative Assistant Nicolette Neile, replacing Catherine McWalter and Denise Allen-Rogers who have moved to posts in other organisations and who I would like to thank for their important contributions to CCP.

This year is a significant milestone for us. It sees the completion of 10 years of very generous core support from the ESRC, and we would like to thank them wholeheartedly for this. It has given us a unique opportunity to establish a Centre of worldwide reputation and achievements which speak for themselves.

During these years, we have published more than 250 articles, books and book chapters, given more than 500 public presentations of our work, hosted numerous practitioner events including discussion sessions and in the last 5 years responded to more than 40 public consultations. CCP is also playing an important role in training the next generation. In addition to the 22 current PhD students attached to CCP, a further 22 have graduated, and 11 post-doctoral fellows have been funded by the Centre over the last 10 years.

From September 2014, CCP will be entering a challenging and exciting new phase with a much more varied funding base. Competition policy, including consumer policy and regulation, remains an important policy area with numerous unresolved questions and we expect that CCP will maintain its substantial contribution to this. Looking forward, the Centre will still produce high quality academic research with real world relevance and will be a powerful independent voice in competition policy with 26 faculty members on permanent university funding, several Research Associates and more than 20 PhD student members. We will continue to carry out and publish research, respond to consultations and interact with practitioners and academics through our research networks. Our findings will be disseminated through our annual conference, our working paper series, the research bulletin (which will move to an electronic format), and our blog, and we look forward to continuing interactions with other academics and practitioners.

Recent Working Papers

Mergers after Cartels: How markets react to cartel breakdown

Stephen Davies, Peter L. Ormosi and Martin Graffenberger, CCP Working Paper 14-1

Supermarket Promotions and Food Prices

H. Lan, T.A. Lloyd and C.W. Morgan, CCP Working Paper 14-2

Is the Korean Innovation of Individual Informant Rewards a Viable Cartel Detection Tool?

Andreas Stephen, CCP Working Paper 14-3

Collusion under Private Monitoring with Asymmetric Capacity Constraints

Luke Garrod and Matthew Olczak, CCP Working Paper 14-4

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ESRC Centre for Competition Policy
University of East Anglia, Norwich Research Park,
Norwich, Norfolk. NR4 7TJ UK

Tel: +44 (0) 1603 593715
Email: ccp@uea.ac.uk
Web: competitionpolicy.ac.uk
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