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COMPETITION ASSESSMENT: BRIEF FOR POLICY OFFICIALS

-- Note by the Secretariat --

This document is submitted to the Competition Committee for APPROVAL BY WRITTEN PROCEDURE. Absent comments, it will be considered approved on 25 January 2007.

This document is part of the Competition Assessment Toolkit. It is designed to help government officials assess whether laws or regulations unduly restrict competition and provide guidance on how to achieve policy objectives in ways consistent with competition.

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COMPETITION ASSESSMENT: BRIEF FOR POLICY OFFICIALS[1]

by the Secretariat

1. Introduction

1. Government action is often vital for promoting and protecting public policy goals. One important and legitimate form of government action is the establishment and enforcement of laws, rules and regulations to achieve desirable policy goals. There are often multiple policy options for achieving a given policy goal, so determining a preferred policy is a difficult task requiring careful analysis. When comparing policy options, it is valuable to assess effects on competition because regulations sometimes affect the nature and degree of competition.[2] Competition between suppliers is beneficial because it fosters innovation and growth in the long-run and results in suppliers providing a greater variety of goods and services at lower prices. If regulations are developed with a focus on ensuring that they do not unduly restrict competition, they are more likely to achieve their objectives and to enhance consumer welfare.

2. Up until now, little explicit guidance has existed on how to assess the competitive effects of regulations. This briefing paper provides such guidance by outlining a practical method for regulators to identify important competitive restrictions. The method uses a set of threshold questions (a "Competition Checklist") that show when proposed regulations may have significant potential to harm competition.[3] A Competition Checklist can help policymakers focus on potential competition issues at an early stage in the policy development process. For the majority of regulations, no significant harm to competition would be expected. In those situations where harm to competition is most likely, an in-depth competition assessment is warranted, probably involving consultation with the government's regulatory "gatekeeper" and the government agencies with expertise in competition.

3. To help regulators address potential competition problems, this brief identifies alternatives that may offset or mitigate potential harm to competition while continuing to achieve the desired policy objectives. Note that even when there is a potential competition problem indicated by the Checklist, that does not mean there is necessarily an actual problem; rather, it means that more careful analysis is worthwhile to ensure that *if* there is an undue restriction on competition, policies can be modified.

4. The rest of this summary explains the three categories of the "Competition Checklist".

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1 This briefing paper has been prepared by Sean Ennis in conjunction with more detailed papers prepared by Rex Deighton-Smith and Vivek Ghosal.

2 The term "regulation" henceforth refers to both primary and subordinate legislation.

3 For a more developed version of the methodology, see DAF/COMP(2007)6 "Competition Assessment: Guidance". For a description of potential institutional options for implementing competition assessment, see DAF/COMP(2007)7 "Institutional Options for Competition Assessment".

Competition Checklist
for the conduct of competition assessments

A competition assessment should be conducted if the proposal has any of the following 3 effects:

(1) Limits the number or range of suppliers

This is likely to be the case if the proposal:

- Grants exclusive rights for a supplier to provide goods or services
- Establishes a license, permit or authorisation process as a requirement of operation
- Limits the ability of some types of suppliers to provide a good or service
- Significantly raises cost of entry or exit by a supplier
- Creates a geographical barrier to the ability of companies to supply goods or services, invest capital or supply labour

(2) Limits the ability of suppliers to compete

This is likely to be the case if the proposal:

- Controls or substantially influences the prices for goods or services
- Limits freedom of suppliers to advertise or market their goods or services
- Sets standards for product quality that provide an advantage to some suppliers over others or that are above the level that many well-informed customers would choose
- Significantly raises costs of production for some suppliers relative to others (especially by treating incumbents differently from new entrants)

(3) Reduces the incentive of suppliers to compete vigorously

This may be the case if the proposal:

- Creates a self-regulatory or co-regulatory regime
- Requires or encourages information on supplier outputs, prices, sales or costs to be published
- Exempts the activity of a particular industry or group of suppliers from the operation of general competition law
- Reduces mobility of customers between suppliers of goods or services by increasing the explicit or implicit costs of changing suppliers

2. Limits on the number or range of suppliers

5. Limiting the number of suppliers creates a risk that market power[4] will be created and competitive rivalry will be reduced. When the number of suppliers declines, the possibility of co-operation (or collusion) between them increases and the ability of individual suppliers to raise prices can be increased. The resulting decline in rivalry can reduce incentives to meet consumer demands effectively and can reduce long-term economic efficiency. While there are sound policy reasons why policy makers may sometimes limit the number or range of suppliers, as discussed below, the policy benefits of entry limits need to be balanced against the fact that ease of entry by new suppliers can help prevent existing

[4] Market power of suppliers is the ability to profitably increase price, decrease quality, or decrease innovation relative to the levels that would prevail in a competitive market.

suppliers from exercising market power. Market power leads to higher prices, lower quality and less innovation.

2.1 Grants of exclusive rights

6. A grant of an exclusive right to produce a certain good or provide a certain service represents the establishment of a regulated private monopoly. Historically, the grant of an exclusive right frequently occurred in the context of a "natural monopoly".[5] The grant of exclusive rights, particularly if given long duration, has frequently been considered a means of encouraging substantial investments in infrastructure that may be unlikely to occur without the incentives provided by the guaranteed market access which the grant of an exclusive right provides.

7. Exclusive rights are likely to yield monopoly pricing and other problems of market power. Such results may not be fully avoided through regulation because regulators often experience a low level of success in preventing the exercise of market power and protecting consumers. Therefore, such rights should be established only with great care and after careful consideration of alternative ways to achieve the same objectives. If established, the duration of such rights can be limited. In addition, public authorities may consider distributing such exclusive rights through bidding, for example over the prices to be charged, to ensure that they are allocated in the most efficient fashion.

2.2 Establishment of a licence or permit system as a requirement of operation

8. Licenses or permits required for operation necessarily restrict entry. Qualifications requirements can take the form of minimum standards for formal education and/or experience and may include good character requirements. At times, a "public interest" test may be applied that requires that potential entrants demonstrate the "need" for an additional service to be provided and, in some cases, even that their entry would have no negative impact on the businesses of existing industry participants. In extreme cases, there may be fixed numbers of licensees. While licensing schemes often have well-founded consumer protection objectives, such barriers frequently have the effect of protecting incumbent producers from competition.

9. License or permit requirements are often stricter than is necessary for consumer protection and can unnecessarily reduce consumer choice and create artificial scarcity that raises prices. A guiding principle is that restrictions do no more than necessary to adequately achieve the regulatory objectives.

2.3 Limits the ability of some types of suppliers to provide a good or service

10. At times, governments seek to promote suppliers from certain regions, small suppliers, or suppliers with other special characteristics by limiting the ability of some types of suppliers to participate in a business activity, particularly with public procurement. Such restrictions are typically excessive because they unduly restrict the number of suppliers participating in procurement, reducing competition between suppliers and resulting in higher prices or less desirable contract terms for the government.

11. Where regional or small business policy objectives are sought, alternatives include a range of direct subsidies and/or tax benefits, provision of a more favourable regulatory environment in key areas, or the use of publicity/educational campaigns. In some cases, targeted subsidies will enhance efficiency by ensuring that more suppliers can actively seek business.

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[5] A monopoly exists when a good or service can only reasonably be purchased from one supplier. In a "natural monopoly", one supplier can produce desired output more efficiently and at a lower total cost than two or more suppliers.

2.4 Significantly raises the costs of entry or exit

12. Regulations that raise the costs of entry to, or exit from, a market will tend to discourage some potential entrants and so reduce the number of participants in the market over time. Examples of this kind of regulation include rigorous product testing requirements and requirements to meet unnecessarily high educational or technical qualifications. Governments have sometimes acted to minimise the competitive impacts of such provisions by providing targeted exemptions. For example, low-volume car manufacturers are often exempted from aspects of vehicle testing regulations, or subject to less onerous testing protocols.

2.5 Restricts the intra-national flow of goods, services, capital and labour

13. Regulations sometimes limit the flow of goods, services, capital and/or labour across jurisdictional boundaries, often as an instrument of regional policy. Such limitations, however, artificially reduce the geographic area of competition for provision of a good or service. This may reduce the number of suppliers and potentially allow suppliers to exercise market power and increase prices.

14. Potential restrictions should be assessed based on whether there is a clear link between the restrictions and the achievement of specific policy goals, whether the restrictions are the minimum necessary for achievement of the goal, whether a reasoned analysis suggests the policy goal will be achieved by means of the restriction and whether the restrictions are restricted to a definite and limited time span via explicit regulatory provisions. There is a substantial risk that "temporary" protections develop into quasi-permanent arrangements due to substantial lobbying by the suppliers that benefit from the restrictions. As with the above case of restrictions on access to procurement, there will often be superior alternatives available to achieve the regulatory objective, including direct subsidies and favourable regulatory treatment.

3. Limits on the ability of suppliers to compete

15. Regulation can affect the ability of suppliers to compete in a variety of ways, not all of which are identified here, including through advertising and marketing restrictions, setting of standards for product or service quality and controls over prices at which goods or services are sold. These limits can reduce the intensity and dimensions of rivalry, yielding higher prices for consumers and less product variety.

3.1 Controls the prices at which goods or services are sold

16. Governments often regulate prices in traditional monopoly sectors, such as utilities. These types of price controls are probably helpful to consumers and serve as a counterweight to lack of consumer alternatives. However, price controls are also sometimes applied in situations where there are many potential suppliers to the same consumer. When minimum prices are set, low-cost suppliers are prevented from winning market share by providing better value to consumers. Similarly, when maximum prices are set, supplier incentives to innovate by providing new and/or high-quality products can be substantially reduced and suppliers may effectively coordinate their prices around the maximum price.

17. Minimum price regulation is sometimes a response to extremely vigorous price competition. In these cases, minimum price regulation is generally seen as a means of protecting small suppliers from "unfair" competition. The impacts of such price regulations merit careful evaluation because the result is likely higher prices for consumers or unmet demand. Maximum price regulations are frequently introduced as a necessary corollary to restrictions on entry. An alternative is to permit freer entry to the market.

3.2 Restricts advertising and marketing

18. Regulations that restrict suppliers' ability to advertise or market goods and services often exist to limit false or misleading advertising. Sometimes advertising restrictions are intended to reduce advertising for products or services that are deemed to have a socially negative value or which are subject to excess consumption. At other times, advertising to certain "vulnerable" groups, such as children, may be restricted. Restrictions of this nature, when circumscribed to ensure they are not overly broad, can have significant social benefits.

19. In many cases, however, advertising and marketing restrictions are too broad and unduly restrict competition. Restrictions on advertising and marketing are likely to be particularly onerous for potential entrants, as they restrict an entrant's ability to inform potential customers of their presence in the market and of the nature and quality of the goods and services that they are able to offer. Regulations that restrict only false and misleading advertising are often a viable alternative.

3.3 Sets standards for product quality that provide an undue advantage to some suppliers over others or that are above the level that many well informed customers would choose

20. Regulations setting standards often provide benefits to consumers and can help to promote new types of products by ensuring that new products from different suppliers are compatible. But standard setting can also provide undue advantages to some suppliers over others. One common example is environmental regulations that limit the allowable emissions of a mildly toxic substance. While limiting emissions is often appropriate to protect public health, regulations can be designed in ways that unfairly advantage a small number of suppliers, for instance by requiring a particular technology or by setting unduly strict standards that are difficult or impossible for less well resourced producers to meet. Another example in which standard-setting can have significant anti-competitive impact is setting minimum quality standards for particular product types. There are often sound objectives underlying such standard-setting, such as protection of consumers from risks associated with the use of the product. However, when many consumers prefer lower cost over increased safety, the need for the standard is unclear. Consumer welfare can be reduced by such standards as consumers are prevented from buying cheaper, lower quality goods that they would prefer, even when fully informed of all associated risks.

21. Alternatives exist to stricter product standards regulations. For example, when minimum standards are pursued for consumer protection reasons, it may instead be possible to require disclosure of certain product characteristics. Where major changes in emissions standards are contemplated, governments can seek to minimise anti-competitive impact by permitting trading of emission rights or providing temporary assistance to smaller suppliers in order to help them meet the new requirements.

3.4 Raises the costs of some suppliers relative to others

22. At times, regulations have the unintended effect of raising costs for some suppliers relative to others. One source of cost asymmetry is regulations that unnecessarily require the use of one technology of production over another. Another source is "grandfather clauses" that exempt current suppliers from a regulation but apply the regulation to new entrants. Such arrangements have substantial potential to distort competitive relations within the industry by raising costs to some suppliers to a substantially greater extent than others. This can impede entry, reduce innovation and lower the intensity of competitive pressure in the market. While creating cost differentials can be harmful, that is not to say that regulations should affirmatively seek uniform supplier costs.

23. For occupational qualifications, grandfather clauses are often implemented based on the belief that extensive practical experience of long established practitioners is an adequate substitute for a higher

level of formal qualification. In relation to productive technologies, grandfather clauses are often implemented to ensure adequate time exists to amortise the sunk costs of previous investments. The anti-competitive impact of grandfather clauses can be minimised by ensuring that they are time-limited, rather than permanent. More generally, a sceptical approach is appropriate for arguments in favour of grandfather clauses, as the clauses often defend vested interests from potential competition.

4. Reductions in the incentives for suppliers to compete vigorously

24. Regulations can affect supplier behaviour not only by changing the suppliers' ability to compete but also by changing the incentive of suppliers to act as vigorous rivals. Two of the main reasons why suppliers may compete less vigorously are first, that some regulations may have the effect of facilitating co-ordination between suppliers and, second, that some regulations may have the effect of reducing the willingness, ability or incentive of customers to switch between different suppliers. Other reasons suppliers may compete less vigorously exist, such as profit or market share limits that restrict the potential reward to competing. Cartel-like behaviour[6] may be more readily generated under self-regulatory or co-regulatory regimes, by increasing the sharing of supplier output and price information or by excluding an industry or sector from the reach of competition law. Cartels are harmful because they restrict output and raise prices, making consumers worse off.

4.1 Self-regulation and Co-regulation

25. When an industry or professional association takes full responsibility for regulating the conduct of its members, without government legislative backing (often at the urging of government) the term "self-regulation" is used. However, when government provides legislative backing to rules that are developed at least in part by the industry/professional association, the term "co-regulation" is used. Self-regulatory and co-regulatory structures can yield substantial benefits by ensuring that technical standards are appropriate and that standards advance with technology.

26. However, these structures can have significant anti-competitive impacts. In particular, industry/professional associations often adopt rules that reduce incentives or opportunities for vigorous competition between suppliers of goods or services, such as advertising restrictions and rules that prevent discounting. In addition, unduly strict qualifications requirements may reduce entry to the market. Government should retain powers to prevent attempts by the industry/professional association to use regulatory powers in an anti-competitive manner. This may include ensuring that the relevant government authorities have the right to approve, or refuse to approve, association rules and, as required, to substitute their own should the association continue to propose unacceptable rules.

4.2 Requirements to publish information on supplier prices, outputs or sales

27. Regulations that require market participants to publish information on their prices or output levels can significantly assist in the formation of cartels, since a key requirement for cartel operation is that participants in the cartel can effectively monitor their competitors' (or co-conspirators') market behaviour. Cartels are more likely to arise where there are fewer participants in the market, where entry barriers are high, where suppliers' products are relatively homogeneous and where information about price or output changes is available either before or soon after the price or output changes.

28. Regulations requiring the publication of information such as price and output levels may be adopted to improve consumer information and, at times, can improve the efficiency of markets. However,

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6 A cartel exists when competitors make an agreement with a goal of increasing their collective profits by restricting competition, for example by setting a price, limiting supply, sharing profits or rigging bids.

when cartel formation is likely, such requirements are more likely to have a net negative impact. Alternatives exist to publishing all collected data. When the information is gathered primarily for government policy making, there may be no need to publish it at all. When the purpose is to aid consumers or provide general statistics, aggregate statistics support cartels less than supplier-specific statistics.

4.3 Exemptions from general competition laws

29. In many countries, particular suppliers or economic sectors benefit from exemptions from the general competition law. In some cases, these sectors are subject to their own, sector-specific competition laws. In other cases, no restrictions exist on anti-competitive conduct in these sectors. Where a substantial derogation from the general application of competition law exists there is a clear risk of cartels, pricing abuses and anti-competitive mergers[7] resulting.

30. Where a specific rationale for the continued existence of exemptions has been identified, consideration should be given to the means by which their scope can be minimised. For example, a legislated monopoly requiring all producers of a particular commodity to sell to a licensed intermediary may be inferior to a system that allows producers to engage in cooperative selling arrangements, but does not compel them to do so.

4.4 Reduces the mobility of customers by increasing the costs of changing suppliers

31. Regulations can make consumers more willing to switch suppliers by affecting "switching costs" – the explicit and implicit costs borne by a consumer in changing from one supplier to another. Switching costs may arise for various reasons, including unduly long contract terms or tying of assets to suppliers in a way that makes switching inconvenient, as with tying a phone number to a given service provider. When consumers face high switching costs, suppliers can charge higher prices for their goods or services. Suppliers therefore often seek to create high switching costs, sometimes through promoting policies that will ensure high switching costs.

32. The pro-competitive impact of reducing or eliminating switching costs can be large so policymakers should seek to avoid policies that raise switching costs for consumers. Where there is a clear risk of switching costs being imposed, the inclusion of provisions in the regulatory structure that will limit or prohibit their use may be advisable. Due care should be taken to ensure that legitimate costs of consumer switching are considered.

5. Proportionality in undertaking competition impact assessments

33. Identifying regulations that may unduly restrict competition is an important step for improving quality of regulation. The categories in the Competition Checklist provide a reliable initial basis for identifying regulations that may give rise to an anti-competitive impact. The sub-points of each category indicate the main but not exclusive ways in which regulations may unduly restrict market rivalry.

34. The relative importance of different anti-competitive impacts can vary substantially. The extent of the competitive effect analysis to be undertaken should be commensurate with an initial assessment of the likely extent of the anti-competitive impact identified. In making this assessment, a clear view needs to be developed about the nature and extent of the affected goods, services and consumers. A primary issue is the ability of consumers and suppliers to substitute between different goods or services, including those that are not covered by the regulation.

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[7] A merger is a combination of one (or more) previously independent suppliers to form one larger supplier.

35. Only a minority of regulations actually have the potential to unduly constrain market activity, but when an initial assessment using the Checklist suggests that there is a potentially excessive constraint on market activity, a full competition assessment is worth performing and merits serious attention. A full competition assessment includes (1) clearly identifying policy objectives, (2) stating alternative regulations that would achieve the policy objectives, (3) evaluating the competitive effects of each alternative and (4) comparing the alternatives. To the extent that the competition assessment identifies significant potential for a weakening of competitive rivalry within the affected industry or related industries, policymakers should seek the least anti-competitive alternative that would achieve the policy goal.

36. In circumstances where an alternative, less anti-competitive regulatory approach for achieving the identified policy objective cannot be found, the benefits and costs of such a regulatory approach should be weighed against each other. The analysis should conclude the regulation is justified only if the benefits from the adoption of the anti-competitive regulation exceed the costs, including the costs of the anti-competitive impact.