Competition in public services

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Introduction

Reform of public services is a subject of wide public interest and concern.

Barely a day passes without public debate about reforms to health, education, fire services, police – or the wider the financial challenges facing public services.

I’d like to think that, at the OFT, we’re well-placed to offer a distinctive viewpoint on aspects of reform.

Our experience of analysing markets gives us a unique perspective on competition: where and when it can bring benefits and how best to introduce it. And we have the powers – and in some circumstances, the legal duties – to intervene to support competition in public services. Although I can’t speak for the future Competition and Markets Authority, I understand that they too see this as a critical part of their function.

I will do two things today. First, draw out some lessons for introducing competition into public services, especially around market design. And second, set out some of the OFT’s priorities.

Lessons from history

David Cameron stated in February 2011:
‘We will create a new presumption – backed up by new rights for public service users and a new system of independent adjudication – that public services should be open to a range of providers competing to offer a better service [...]’

He continued:

‘Instead of having to justify why it makes sense to introduce competition in individual public services – as we are now doing with schools and in the NHS – the state will have to justify why it should ever operate a monopoly.’

It is core to the OFT’s approach that competition has the potential:

- To drive existing providers to ‘up their game’ in response to the actual or potential threat of competition,

- To allow new providers to enter a market and for them to offer a better deal for consumers, in terms of service, quality or value for money, and

- More generally, for the process of competition to drive innovation and change in markets, not only in terms of goods and services, but also business models and approaches.

Consistent with these views:

- External analysts have identified the potential gains from higher productivity through competition in public services: the LSE Growth Commission noted in 2011 that ‘intelligent policies to improve product market competition and enhance labour market flexibility are ways of improving productivity in the public sector, just as they have done in the private sector.’¹

- Analysts have argued that significant gains could be achieved through applying more efficient, competitive ways of delivering services: taking procurement as an example, the FT recently noted

¹ http://cep.lse.ac.uk/conference_papers/15b_11_2011/CEP_Report_UK_Business_15112011.pdf
that outsourcing doubled in the last four years to £20 billion and is likely to double again in the next two.²

- And a 2012 joint report from the Social Market Foundation (SMF) and Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA) argued that ‘better commissioning can help improve social outcomes and foster new markets for social and economic innovation.’³

So, if these are the potential benefits, and there is a commitment to open up markets to deliver them - in a wide range of different ways - how should it be done?

After all, transferring a public monopoly into private ownership will not in itself create these conditions. It could worsen the situation given the lack of public accountability. And simply increasing the number of providers does not guarantee more real competition, if barriers to entry and exit are high and choice is difficult to exercise.

I will consider a series of what were once thought of as public services, now opened to full competition. Then I’ll consider a set of themes.

Telecoms

It is difficult to think of telecoms as a state-provided service.

The idea that, 30 years ago, it was necessary to call a state monopoly, British Telecom, to replace your telephone handset seems alien. Now, strong competition features at most levels of the supply chain. Only the fixed local loop remains a natural monopoly. This competition has yielded significant consumer benefits, including dramatic reduction in price and much greater choice.

But it is worth remembering that telecoms liberalisation has been a process of evolution.

² www.ft.com/cms/s/0/13a4e68e-6610-11e2-bb67-00144feab49a.html
The original duopoly market design of Mercury as a full line competitor to BT was, after time and limited success, superseded by opportunities for entry presented by rapidly changing technology. Indeed as technology evolved, so parts of the supply chain previously thought to be network monopolies could be opened up to a diverse range of suppliers.

It is possible to draw many lessons from the telecoms story. I’d like to focus on three:

• First, while it is important to have a competitive market design at the start, it is also crucial that the market design and regulation is flexible to new technologies and business models. Ex-ante regulation through licensing, supply obligations and tariff-setting carries an ever-present risk of restricting competition and protecting incumbent suppliers. It is credit to Ofcom, and its predecessor Oftel, that it has adapted its regulatory regime to market dynamics.

• Second, it’s important not to underestimate the incumbency advantages of public providers or former public providers. As the former public monopoly, BT had significant competitive advantages over new rivals: some formal advantages like access to the local loop and some cultural ones like networks of contacts and former staff in key areas of the market. Maintaining a level-playing field between different providers has required sustained regulatory effort. There are distinct lessons here for markets, like health, that are being opened up with strong incumbent public providers.

• Third, consumers need to have the confidence, information and ability to switch providers. The consumer journey in telecoms has been just as dramatic: from inactive ‘users’ of the public monopoly, to some of the most active consumers in any market in the case of mobile telecoms. But this journey has not been straightforward. Obstacles to switching like number portability have had to be overcome. And the ‘confusopoly’ of tariff structures is a major barrier at the retail level.

Airlines
If telecoms have shifted from being considered a core public service to a more ‘normal’ commercial market, what about airlines?

Starting in the late 1980s, liberalisation facilitated the entry of new low cost carriers, introducing new business models and processes such as more efficient booking methods and extensive outsourcing. The price of an economy class ticket provided by traditional carriers fell by over 66 per cent between 1992 and 2002. These are classic benefits from competition.

But airline liberalisation has not been plain sailing.

Outside the EU, many routes remain highly concentrated. And as might be expected in concentrated markets, we have seen cases taken by competition authorities where airlines have colluded to share markets or dampen price competition.

Airline liberalisation also illustrates well the difficulties in creating effective competition where there are supply constraints and rationing mechanisms. Protecting rights to landing and take-off slots at capacity constrained airports, even where that means operating uneconomic services, has been one means for incumbents to protect their position. It is worth asking whether it is right to carry over a system of pre-existing exemptions into a liberalised market, or design a new system for allocating scarce capacity. Parallels for liberalising some other public service markets are clear.

Airports, as well as airlines, were privatised. However, there was limited liberalisation – several airports were held by BAA, which became in essence a regulated monopoly. One of the reasons the OFT referred BAA’s airports to the Competition Commission (CC) was to try to alleviate the bottlenecks at Heathrow by creating rival competitors at Gatwick and Stansted: the CC’s most recent work found that the sale of Gatwick have already started to bring benefits to airport users.

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4 DTI (2004), The Benefits from Competition: some illustrative UK cases.
The story of airline liberalisation also highlights the significance of barriers to exit. For a long time across Europe, the exit of incumbent flag carriers was prevented by direct state subsidy or indirect subsidies like state pensions. This prevented or delayed expansion of lower cost entrants and meant prices were higher for longer than they should have been.

Energy

The liberalised energy market was designed with strong competitive arrangements upstream (in electricity generation and in gas exploration and production), while natural monopoly aspects (‘pipes and wires’) have always been price controlled. Over time, competition was introduced at the retail level. Customers were free to switch away from their local utility and price controls were rolled back from retail markets.

The reforms were generally regarded to be successful in the early phase, delivering improvements in unit costs (in network and generation) and customer service. The reformed electricity market delivered substantial investment in new generation capacity in the form of smaller scale, more efficient gas power stations (the so called ‘dash for gas’).

But we have also seen challenges to competition in energy markets. I will cover three.

First, there has been a consolidation of ownership of energy supply companies and generation assets in the hands of a relatively small number of companies. The so called ‘big six’ UK energy supply companies currently have a market share of around 98 per cent and own around 70 per cent of UK generation capacity. The difficulty of managing wholesale price risk drove the sector towards vertical integration – balancing generation capacity with a retail customer base within the same company. While this is a sensible outcome in risk-management terms, it poses a challenge in competition terms: barriers to entry are much higher if you have to enter both upstream and downstream to compete effectively. There is a lesson here for policy makers dealing with other public service markets about understanding the risks to business entailed by market design and how businesses might, in time, try to mitigate them.
Second, the energy sector has faced a diverse set of public policy goals and a changing context – including emissions targets and changes in international demand. Reconciling these varied public policy goals, including competition, especially in a sector where investment timescales can be lengthy, is genuinely very difficult. If there is a wider lesson here, it is to be very aware about such potential tensions in the design of markets and regulatory regimes when public services are opened up. Being explicit about those tensions may be the best approach.

Third, we have seen problems at the sales level – for example, in terms of the ‘confusopoly’ that makes choice difficult to exercise and mis-selling. Ofgem has taken on high profile mis-selling licence enforcement cases (notably fining SSE a record £10.5 million). It has also introduced measures to limit the number of tariffs offered by energy supply companies. It is worth considering whether there are lessons here for providing information to users of some other public services in future.

**New markets, old issues**

As new public markets are created, it is important that we keep these lessons in mind. Departments need to capture learning from past liberalisation and current initiatives.

The OFT can draw out common issues and lessons from public markets and present them across government. We have a duty to advise Government about competition matters and our publications on Choice and Competition in Public Markets, on Orderly Exit, and on Competition in Mixed Markets, have been intended to inform policy makers.

Broadly, we see four common issues in public markets

- Failures of market design and competitive neutrality
- Barriers to entry, expansion and exit
- Concentration of providers, and
- Lack of transparent information for consumers

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7 Under the Enterprise Act 2002, Part 1, Section 7
8 www.ofg.gov.uk/713560/publications/reports/advocacy/of1214
10 www.ofg.gov.uk/shared_ofg/economic_research/of1242.pdf
I will say a few words about the first three. Our views on the fourth, the importance of transparent information for consumers – for them to be able to access, assess and act – would not come as a surprise to anyone familiar with the OFT’s work across private and public markets.

Market design

Market design needs to flow from the public policy objectives intended from opening up a market.

For example, in health it has been considered necessary to fix price tariffs and allow competition to focus on quality to avoid competition focusing on price at the expense of quality. In this context, quality is partly about clinical outcomes, partly about other things like access and service.

But articulating clear objectives can be difficult when the purpose of introducing choice and competition itself varies: sometimes to address concerns about quality, choice or innovation; in others to reduce costs. Weighing up these points is an important first step in market design.

For example, our 2011 case study on the Flexible New Deal for welfare-to-work showed that while one of DWP's overarching objectives in its Commissioning Strategy was to create competition 'for' and 'in' the market by contracting to a number of prime providers, many such providers in fact reported a significant lack of clarity as to the type of market DWP was striving to create, 'with some respondents reporting a tension between a desire to be both laissez-faire and to steward the market.’¹¹ This lack of clarity may have contributed to uncertainty among potential suppliers and possibly fewer new entrants to this market.

Barriers to entry, expansion and exit

Barriers to entry and expansion lie behind many problems of competition in public markets. Entry barriers can often arise from the way in which government procures and commissions services. Two-thirds of

commissioners, providers and regulators we surveyed in 2011 thought there were significant barriers to entry in public markets.¹²

Long and complex bidding processes create entry barriers by increasing costs. They disproportionately favour large suppliers and incumbents. Equally, requirements for tenderers to have extensive experience in the market favour incumbents and rule out new and innovative businesses.

A concrete example of barriers to entry came up in our market study on dentistry.¹³ It highlighted how the long-term NHS dental contract in England acts as a barrier to entry and expansion. Having a contract to provide NHS dental treatment is crucial to the commercial viability of most dental practices. Yet the majority of existing contracts are indefinite and only a small volume of new contracts are put out to competitive tender each year. When contracts are tendered, the process of awarding them can be lengthy and place significant weight on past experience. The effect has been to insulate dental practices with an NHS dental contract – almost universally being privately-operated, profit-seeking businesses – from competition. New practices trying to enter the market face limited opportunities. Poorly performing practices face limited incentives to improve. High quality, popular practices find it hard to expand. It is no surprise that practices with NHS contracts were, on average, valued at more than 120 per cent of their fee income, while purely private practices were mostly valued at less than 100 per cent of turnover.¹⁴

Our recommendation for the Department of Health on dentistry was that payment for NHS dental services should be based on a principle related to following the patient so that any licensed dentist can compete for NHS patients.

Barriers to exit can be equally harmful to competition. When poor or inefficient suppliers are prevented from exiting a market it can significantly undermine incentives for rivals to compete for market share.

The need to ensure continuity of service, for example in the provision of schools and hospitals, can be an important source of barriers to exit. As

¹² Ibid.
¹³ www.oft.gov.uk/OFTwork/markets-work/dentistry/
¹⁴ Ibid.
noted in our report on Orderly Exit,\textsuperscript{15} competition involving a diversity of suppliers is one of the best ways of ensuring continuity of service by having a number of alternative providers that can take over from a failing provider. Continuity regimes, where needed, should focus on mitigating the impact of exit rather the mitigating the risk of exit. If public markets are being opened up to competition, a credible risk of exit – albeit potentially having a different meaning to that in some other markets – is an important dimension. Decisions in the health sector to allow trusts to go into administration, whilst safeguarding services to patients, should be seen in this context.

Concentration

Sustained barriers to entry and exit or initial market design can be both causes of public markets being concentrated in the hands of a few providers. Concentration in public markets means reduced choice for commissioners or users and reduced competitive pressure on providers. It may also increase the risks to continuity of service.

The OFT sees risks ahead about the concentration of some public service markets. We are concerned when we see concentration that suggests that, in practice, markets are only contestable by established incumbents. It is then a short step for those incumbents not to compete with each other. When they explicitly agree not to compete, we can pursue them under competition law. But tacit collusion – where each firm has a niche and does not challenge outside that area – is something that competition authorities have real difficulty tackling, and which is better considered through procurement, commissioning and market design.

**The OFT’s role in public markets**

Analyse and advise

I hope that the lessons and themes I’ve described today make the case for people with experience and skills of competition and markets being involved when services are opened up to competition.

\textsuperscript{15} \url{www.oft.gov.uk/OFTwork/public-markets/choice-and-competition/orderly-exit/}
This is one of the OFT’s roles. This can take the form of bespoke advice on particular market issues. Or it can involve market studies and calls for information to investigate whether competition is working in the interests of service users and taxpayers, such as the one on dentistry to which I’ve referred.

In many public markets, such as education, health and local government services, sufficient time has passed since forms of competition were introduced to have a thorough and evidence based look at how competition is working. Competition in the supply of services on which public services in turn rely, such as IT, is another such area. We expect to do more work in all these areas over forthcoming months.

Enforce and apply competition law

In addition to advice, we also have a role applying competition law across the economy – including commercial firms conducting public services and public undertakings themselves in some circumstances.

However, we recognise that there are ways to do this. In the commercial sector we have achieved success – and won a Global Competition Review award – for our compliance work.\textsuperscript{16} And this is why we are rolling out a compliance programme with public bodies to raise awareness of the law and seek to prevent anti-competitive behaviour.

We will seek other approaches to full enforcement where appropriate.

For example, last summer we secured voluntary assurances from eight NHS Hospital Trusts that they will no longer exchange commercially sensitive information about their Private Patient Unit (PPU) prices, to ensure they comply with competition law.\textsuperscript{17} We have urged all Trusts to take steps to ensure compliance with competition law when engaging in commercial activity. We also secured voluntary assurances from some school suppliers in 2011, to secure greater choice and improved price competition for their public sector customers.\textsuperscript{18}

\textsuperscript{16} \url{www.oft.gov.uk/OFTwork/competition-act-and-cartels/competition-law-compliance/}
\textsuperscript{17} \url{www.oft.gov.uk/news-and-updates/press/2012/71-12}
\textsuperscript{18} \url{www.oft.gov.uk/news-and-updates/press/2011/130-11}
But we will also consider full enforcement action against public bodies where we have evidence of abuse of market power or anti-competitive agreements – or indeed breaches of consumer protection law where the OFT is best placed to act.

Merger control is another area of competition law. For example, we have an important role to play in healthcare mergers, including under the Health and Social Care Act 2012. In January 2013, we referred the proposed merger of two NHS foundation trusts located in Poole, Bournemouth and Christchurch to the Competition Commission for in-depth investigation.

Merger control is an important part of thinking ahead about the development of markets over the next five, 10 or 20 years. But, again, it is important for competition authorities to recognise that grappling with, say, information requests about mergers is difficult. In other markets, such as retailing, there has been a substantial evolution of approaches. It is right that as we apply merger law to public healthcare markets, for example, we will need the same process of evolution and engagement. I look forward to working with the Competition Commission and Monitor on this.

**Future public markets work**

As the competition and markets regulator for the whole economy, we must prioritise our limited resources. Given the increasing role of public service markets in economic growth, this is an area we expect to become increasingly visible in over the next few months.

I hope I’ve set out today why there is role for our expertise. Our role here is double sided: we can analyse and advise, but we also enforce the law. We have two sets of duties and we intend to deliver them both. The Government, in the Budget, made a renewed commitment to consider and accept the OFT’s recommendations, which is welcome.19

Our approach to public markets mirrors our work elsewhere: we are committed to influencing behaviour across markets and will publicise our advice or enforcement in one area to maximise the lessons for other comparable sectors.

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And, although I cannot speak for the leadership team of the new CMA, which will take on the competition and markets roles of the OFT in 2014, everything I have heard suggests that public service markets will be a priority for them too. Given all of this, I would argue that the continued involvement of competition authorities in public service markets should be referred to in the Government’s forthcoming strategic steer for the CMA.