Edexcel A level Economics
Theme 3
Markets and business behaviour
2018/19

Course companion 4

Government intervention:
To control monopolies and mergers
To promote competition and contestability
To protect suppliers and employees
The impact of government intervention
Limits to government intervention

Name: ______________ ______________

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Block: 2__

Regulatory framework – overview:

Competition and Markets Authority (CMA)

Created in April 2014 taking over functions of Competition Commission (CC) and Office of Fair Trading (OFT).

An independent non-ministerial government department, working to promote competition, to make markets work well for consumers, businesses and the economy.

Functions

- Investigating mergers which could restrict competition
- Conducting market studies & investigations in markets where there may be competition & consumer problems.
- Investigating where there may be breaches of UK or EU prohibitions against anti-competitive agreements & abuses of dominant market positions.
- Bringing criminal proceedings against individuals who commit the cartel offence.
- Enforcing consumer protection legislation.
- Co-operating with sector regulators (e.g. OFGEM) & encouraging them to use their competition powers.

Powers

- Fine guilty firms up to 10% of global sales revenue.
- Prosecute directors, leading to unlimited fines and/or up to five years imprisonment.

Mergers and takeovers

- Merger subject to CMA investigation if firms involved in proposed merger / acquisition have **combined market share in UK of more than 25%** or if the combined assets of the firms exceed £70 m worldwide.

The result of an enquiry by the CMA is given in a **report,** which explains the CMA's findings and lists its policy recommendations. Based on the findings, the CMA will decide whether or not the merger may proceed and if so, under what **conditions.** If the merger would lead to ***'substantial lessening of competition'*** it is likely to be blocked.
However, if the merger is in the **national interest** it may go ahead regardless of impact on competition, e.g. Sept 2008 merger between Lloyds TSB & HBOS with 35% market share.
The **possibility of investigation** acts as an **incentive** to firms **NOT** to abuse dominant market power.

European Commission

The European Commission is responsible for investigating and punishing firms which breach EU competition law. EU law governs competition policy when it affects trade **across national boundaries** in the EU.

- e.g. the EU competition authorities would prosecute UK firm caught fixing prices across the EU with a French and German firm.
- A firm can appeal to the European Court of Justice against any fines imposed by the European Commission.
- ‘Leniency policy’ means that the first company to hand over inside evidence of a cartel does not get fined.

3.6.1 – Government intervention:

a) Government intervention to control mergers

Reasons for government intervention:

Mergers and takeovers between firms can lead to:

- Greater market concentration and monopoly power with loss of allocative efficiency
- Higher prices for consumers
- Less consumer surplus and higher producer surplus if prices and profits rise
- Job losses through rationalisation
- Asset stripping and financial gains for some at the expense of others
- Less choice for consumers
- A drop in quality of goods/services due to a lessening of competition

Revision of monopoly diagram to illustrate allocative inefficiency:

And therefore the government may wish to consider whether some mergers should not go ahead.

However, there are also many benefits to mergers such as:

- It may reduce overcapacity in a market
- Greater profit may enhance R and D leading to greater dynamic efficiency
- Economies of scale leading to cost savings could lead to lower prices for consumers
- UK firms may be better able to compete globally

Revision of economies of scale diagram to illustrate benefits of merger

The competition authorities would need to weigh up these factors when considering each referred merger/takeover.

UK and EU mergers policy

The CMA (Competition and Markets Authority) is the UK's economy-wide competition authority responsible for ensuring that competition and markets work well for consumers.
The CMA has a function to obtain and review information relating to proposed/referred mergers, and a duty to refer for an in-depth investigation any relevant merger where it believes that it may be the case that the merger may be expected to result in a *substantial lessening of competition* in a UK market.

The CMA also has the responsibility to bring to the attention of the Secretary of State any merger it is investigating which it believes raises a 'public interest' concern.

Under the EU Merger Regulation, the European Competition Commission has jurisdiction over those mergers that have an 'EU dimension' (calculated in terms of the turnover of the merging undertakings). These proposed mergers have to be notified to the Commission. In addition, the Commission may, if requested, review mergers referred to it by the CMA for consideration.

Mergers are considered 'relevant' for referral to the CMA if:

- At least one of the firms is active in the UK
- Joint annual turnover would exceed £70m OR
- Joint share of market supply would be 25% or more

As set out in the Enterprise Act of 2002. Further investigation would then take place only if a 'substantial lessening of competition' might occur if the merger went ahead.

Mergers should be notified to the European Competition Commission if the firms involved are operating in more than one EU member country and if

- Combined worldwide turnover for firms would exceed €5,000m
- EU-wide turnover of at least 2 of the firms would exceed €250m

Case study: mergers in the phone market.

1. **BT and EE**

BT Group's takeover of mobile phone network EE has been given final clearance by the Competition and Markets Authority (CMA). The £12.5bn deal brings together the UK's largest fixed-line business and the largest mobile telecoms business. The CMA said it was unlikely to harm competition as BT was "smaller in mobile" and EE a "minor player" in broadband. But rival Vodafone said it still had "wider market concerns".

The deal creates a communications giant covering fixed-line phones, broadband, mobile and TV. John Wotton of the CMA said: "The evidence does not show that this merger is likely to cause significant harm to competition or the interests of consumers."

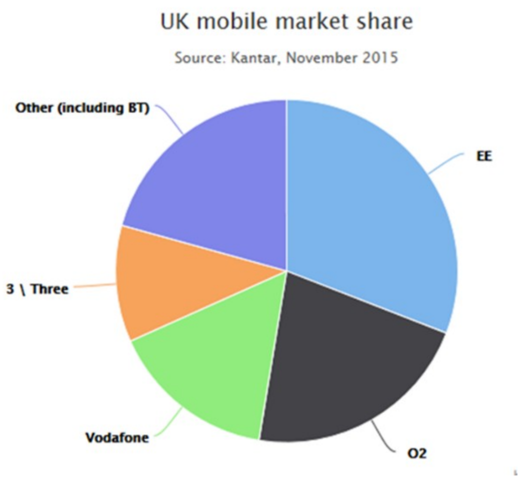
BT chief executive Gavin Patterson said "The combined BT and EE will be a digital champion for the UK, providing high levels of investment and driving innovation in a highly competitive market. I have no doubt that consumers, businesses and communities will benefit as we combine the power of fibre broadband with the convenience of leading edge mobile services. I look forward to welcoming EE into the BT family".

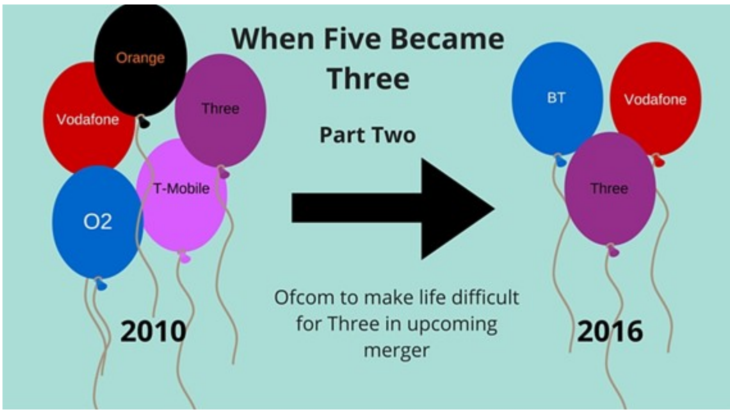
BT has around 88,000 employees in 61 countries, with 72,000 of those working in the UK. It controls 31% of the UK fixed-broadband market, according to Ofcom, and has a 37.6% share of the market for UK home phone traffic. The deal would add EE's 33.8% mobile market share to BT's portfolio.

www.bbc.co.uk and www.cityam.com

2. **Proposed merger between O2 and Three** https://www.youtube.com/watch?v=0jSGKuaYnIQ

- Three wanted to buy O2 for £10.5bn
- Ofcom opposed the merger
- The CMA had previously approved BT/EE merger
- The CMA had serious concerns about the impact on competition of this merger went ahead
- The case was referred to the European Commission for a ruling





Arguments for allowing the merger	Arguments against allowing the merger
To create a balance to the market power of EE	Too few mobile firms may lead to less competition, higher prices for consumers and less choice
Potential economies of scale	New firms would have 4 out of every 10 customers in UK
More funds for investment would be available	A less efficient market outcome

The European Commission has blocked Telefonica's sale of O2 to CK Hutchison, the owner of Three. The planned deal was worth £10.3bn, and would have left the UK with just three major mobile phone network operators. But Europe's competition commissioner, Margrethe Vestager, said she had strong concerns about the takeover, ruling that it would reduce customer choice and raise prices.

"The goal of EU merger control is to ensure that tie-ups do not weaken competition at the expense of consumers and businesses," said Ms Vestager. "We want the mobile telecoms sector to be competitive, so that consumers can enjoy innovative mobile services at fair prices and high network quality."

The decision ruled that concessions offered by Hong-Kong based Hutchison - including a five year price freeze and billions of pounds in investments - "were not sufficient to prevent" the hampering of innovation and network infrastructure development.

www.bbc.co.uk 11 May 2016

Question for discussion:

Why was the BT-EE merger allowed by the regulator while the O2-Three merger was disallowed?

Multiple choice questions on mergers

Barr and Britvic are two of the three largest soft drink firms in the UK. In February 2013, the proposed takeover by Barr of Britvic was referred to the Competition Commission for investigation. There were likely to have been concerns that the takeover would lead to

(1)

A economies of scale

B an increase in consumer surplus

C a decrease in contestability

D a reduction in external economies of scale

E a signal for more firms to enter the industry

Answer

Under the Enterprise Act 2002, the Office of Fair Trading has the power to refer any merger involving more than 25% market share to the Competition Commission for investigation. The investigation is likely to recommend that the merger is **not** allowed to take place if it is likely to result in

A a share price thought to be too high by many potential shareholders.

B a substantial reduction of competition within any market or markets in the UK for goods and services.

C increased consumer benefits such as lower prices and greater choice of product.

D a reduced market concentration ratio in the relevant industry.

E greater contestability in the relevant industry.

Answer **(1)**

Evaluation of merger control:

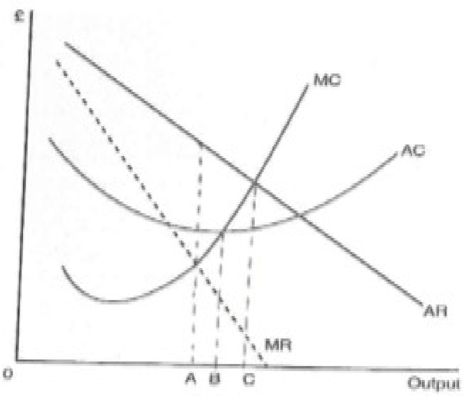
Regulatory decisions regarding whether or not mergers/takeovers should be allowed to go ahead are very complex. A great deal of information must be considered.

It is possible that regulatory failure might occur, with the 'wrong' decision made for the benefit of consumers, firms and the economy, if:

1. The regulator does not have all the relevant information about possible costs and benefits
2. The regulator is influenced in some way to act in the interests of one of the firms in question to the detriment of other stakeholders
3. The cost of investigations is high with a wasteful use of resources
4. There is a significant time lag before a decision is made causing uncertainty in the market

Government intervention to control monopolies

Refer to the monopoly diagram:



1. A profit maximising monopolist would produce at output level ....
2. What is the productively efficient output level?............
3. What is the allocatively efficient output level?..............

Profit maximising monopolists earn abnormal profit at the expense of their customers, reducing consumer surplus and producing a deadweight welfare loss.

1. Define consumer surplus
2. Why would consumer surplus be reduced?

Therefore, it can be argued that monopolies might exploit consumers and that governments should control monopolies or firms with significant monopoly power. There are various ways this could be done:

Price controls or price regulation

Price controls are one of the main methods used by the UK government to regulate privatised monopolies. For example, in 2015 there were price controls on some train fares and on water supply.

On privatising state-owned monopolies in the 1980's/1990's, the UK government appointed a regulator as a **surrogate for competition** to set **price** and maintain **quality** in each industry, until perhaps competition could replace regulation.

Utility regulators:

Ofcom: Telecommunications, including landline, mobile phone services, television and radio.
Ofgem: Gas & electricity (replaced Ofgas & Offer 1999)
Ofwat: Water
ORR: Office for Rail Regulation.

Regulator to prevent abuse of monopoly power by:

Price capping
Price cap: an upper limit for the price increase that a firm can add to their retail prices. The focus is on controlling price to prevent abnormal profits.

- Price limits are set on privatised utilities using a **formula linked to inflation rate**, an **RPI + K** or **RPI - X formula**. The regulatory bodies allow price increases each year at a rate that was a set amount below changes in the RPI.
- Price limits fixed for a **set period of time** e.g. 5 years
- **RPI - X:** This takes the RPI and subtracts a factor X determined by the regulator. X represents the **efficiency gains** that the regulator has determined can reasonably be achieved by the firm, e.g. telecommunications where new technology expected to improve efficiency.
- **RPI + K:** this takes the RPI and allows for the addition of the K factor which accounts for the additional capital spending that a firm has agreed with the regulator is necessary, e.g. for regional water companies required to replace aging infrastructure and train operating companies.

- Price capping can be removed if the industry is successfully opened up to competition. Some price caps have been removed: http://www.nao.org.uk/whats_new/0708/0708342.aspx?alreadysearchfor=yes

Calculations:

1. If the regulator believed that it was possible to achieve productivity gains of 5% per year, and if the RPI was increasing at a rate of 10% per year, then the maximum price increase that would be allowed in a year would be ………………………
2. RPI = 8%, the regulator believes efficiency gains of 3% are possible, allowing a maximum price increase of ……………………

Energy price gaps (Economist.com 27.4.2017)

WHEN Ed Miliband committed Labour in 2013 to freezing Britain's energy prices, David Cameron, who was prime minister at the time, accused him of wanting to live in a "Marxist universe". Less than four years later, the threat to rig energy prices has resurfaced in this election. This time the aspiring Marxist is Mr Cameron's Tory successor, Theresa May.

On April 23rd the government said that setting a price ceiling for the large majority of gas and electricity customers on the highest tariffs would be part of the Conservative manifesto, which is due out on May 8th. It insisted that such a cap was different from Mr Miliband's freeze because it would be administered by the regulator, Ofgem, and would be flexible. Analysts, however, said that in practice there would be little difference. Both approaches risk a return to heavy-handed regulation of the energy market, reminiscent of the 1970s.
The fact that the two biggest parties now see eye-to-eye on the need for intervention in energy markets partly reflects an unpopular surge in domestic electricity bills this year. But it also suggests the market is deeply flawed. In most industries, from airlines to coffee shops, customers are rewarded for loyalty. Yet in the energy industry the most "sticky" clients are penalised with tariffs substantially higher than those offered to new customers.

Last year the Competition and Markets Authority (CMA), Britain's antitrust agency, concluded that 70% of customers of the Big Six energy suppliers—Centrica, SSE, Scottish Power, Npower, E.ON and EDF—had failed to switch from the highest standard variable tariffs (SVTs). On average, in 2011-15 they paid 11% more for their electricity than those on other tariffs. By milking those inactive customers, who are mostly poor, under-educated and elderly, the suppliers boosted their profitability. The CMA found no collusion among the Big Six. But their business model encourages them, as one Tory MP puts it, to treat their longest-serving customers as "chumps". This exacerbates distrust of the industry.
For all its concerns, the CMA refrained from ordering a price cap for people on SVTs, except the poorest, who are on prepayment meters. It said rigging prices risked stifling competition from firms challenging the Big Six with cheaper fixed-rate tariffs, as well as reducing people's incentives to switch.

Mrs May's price cap would ignore those conclusions. It would put politicians back at centre-stage in energy markets, making policy more unpredictable. There are more nuanced ways of lowering default tariffs while preserving competition, and more effective ways to nudge people onto new tariffs. One of the CMA's main recommendations—that companies should have access to information on customers stuck on an SVT for more than three years so that they can offer them better deals—may work. The key is to preserve choice.

Summarise the arguments for and against a price cap on energy as proposed by the Government.

3.6.2 a) The impact of price controls

Diagram: Price controls in a monopoly industry

Price controls in a monopoly industry
At the maximum price of OE, what is the output level? ……………
Without the price control, what would be the profit maximising output level and price? ……………………..
Fixing a maximum price for a monopolist makes the average and marginal revenue curves horizontal for part of these curves.

Discussion: The impact of price controls on monopolies includes:

Evaluation of price controls

There are limitations of this approach, for example, how does the regulator know where to set X and K? It is difficult for the government to know where the cost and revenue curves lie and what is the allocatively efficient level of output.

The company may have better information about costs than the regulator. This is an example of imperfect information (a.................... i.........................). This may result in prices being kept high as the regulator has limited information and may become a victim of **regulatory capture**.

Firms may improve efficiency and look for productivity gains (reduce X-inefficiency) in order to increase profits.However, the firm might achieve its productivity gains by reducing the quality of the goods or by investing less in the future.

As time goes by, if the (RPI-X) system is effective, the X-inefficiency will be gradually squeezed out and the X will have to be reduced as it becomes increasingly difficult to achieve productivity gains.

Price controls could lead to dynamic inefficiency. If the monopolist were to increase investment if allowed to operate at profit maximising level, then future output might be higher or be at a lower price if investment increased future productive efficiency.

RPI + K - allows a firm to keep any profits it makes through greater efficiency gains – this could lead to more dynamic efficiencies long term. However, the regulator might underestimate the efficiency gains a firm can be expected to make, then firms can produce excessive profits

Profit regulation
Another way that monopolists can be controlled is by fixing a maximum level of profit that they can earn. The government should set a level of profit such that the monopolist makes no more profit than if the industry were perfectly competitive. In practice, this is done by calculating what should be the operating costs of the monopolist and adding a rate of return (or rate of profit) on capital employed.

Rate of Return
This regulation method was used originally in the USA before price capping was adopted there, to control utility companies such as electricity and water. It allows a firm to make a certain level of profit based on their capital before the remainder of the profit is taxed at 100%.

Impact of profit regulation:

Unlike price-capping, there is no incentive to make efficiency gains that increase profits.

Firms are not rewarded for their success but instead are penalised for it and encouraged to make a limited profit.

Firms are also encouraged to overstate the value of their capital to ensure they can increase the rate of return on their investment, in effect, increasing their profits. If they are being awarded a percentage rate of return on capital, the more capital employed, the higher the amount of profit earned. E.g. if the monopolist is allowed to earn a 10% return on capital employed, it will earn twicde the profit if it has capital employed of £2b than if it has only £1b employed.

It requires regulators to have a good understanding of costs and rates of return in the industry. The monopolist has an incentive to predict to regulators that future costs will be higher.The monopolist may attempt to create a situation where there is asymmetric information: the monopolist has more information than the regulator.

Monopolists have little incentive to minimise costs. If they are allowed to cover their costs and earn a profit on capital employed then it doesn't matter to the monopolist whether costs are £100m or £110m. The costs will be covered by the customer.

Quality Standards

A profit maximising monopolist is focussed on profit and not quality. If the way to make high profit is to reduce quality, then customers will receive poorer quality products.

Governments can intervene by setting quality standards. E.g. in the UK, the Post Office has a legal obligation to deliver letters daily to rural areas, despite these services being loss making.

It is in the monopolist's interests to resist the imposition of quality standards. They may suggest self-regulation.

Monopolists may argue that they will be providing products with quality standards in the future and so regulation is unnecessary.

There may be asymmetric information – the government needs to have an understanding of the industry to impose meaningful quality standards.

Performance targets: similar to quality standards, regulator sets targets which it then monitors. This could be:

- Improvements in the quality of service, reduction in number of complaints
- Prices
- Customer choice
- Costs, e.g. setting targets for production costs.
- Minimum investment levels set where there has been under-investment in the past, e.g. water, rail.

E.g. in the UK, performance targets are used for rail travel. Train companies are given targets for the percentage of trains arriving on time. In the water industry, targets for reducing leakage from water pipes.

The firm may face fines if they fail to meet targets

Discuss: Impact of performance targets on firms and customers:

Evaluation of performance targets:

Monopolists may resist the imposition of performance targets, especially if not meeting them results in bad publicity and fines.
Monopolists may find ways of getting around performance targets, e.g. changing train timetables so that train journeys become officially longer, if train companies are given targets for the percentage of trains on time.
Performance targets might have to be changed frequently as monopolists find ways round meeting them without improving the quality of the product provided.
Penalties may benefit customers e.g. train operator must give refunds if train late by more than a certain amount.

Activity - Independent work – summarise the benefits and limitations of these regulatory methods:
Price controls or price regulations (price capping)

Benefits	Limitations

Profit regulation (profit capping) – Rate of return: The firm is allowed to make a certain level of profit based on its capital before the remainder of the profit is taxed at 100%
Return on capital employed (ROCE) = (net profit/capital employed) x 100

- This is intended to act as a cap on prices, as higher prices would mean more profit earned.
- Historically has been used in USA though now being replaced by price caps.

What might be the benefits and limitations of this method?

Benefits	Limitations

Performance/quality targets

Benefits	Limitations

3.6.2 – Activities: Discuss and summarise the impact of government intervention on:

Prices

Profit

Efficiency

Quality

Choice

Activities:

Question 1

Ofwat, the water regulator, has confirmed details of agreements with 18 water companies across England and Wales. Average bills over the next five years have been set at the rate of inflation (RPI) minus five per cent. So bills in real terms will fall, but in nominal terms they may raise depending on the rate of inflation. Thames Water, the country's biggest water company, had wanted Ofwat to allow it to increase its bills by three per cent plus inflation. This was rejected by Ofwat. In fixing prices, Ofwat has lowered the estimated rate of profit on capital employed that water companies will earn from 3.85 per cent to 3.74 per cent.

The promise of lower prices in real terms follows criticism from politicians and consumer groups that many privately owned water companies have profited unfairly from much lower than expected borrowing costs during the current five-year settlement, running from 2010-14. Tony Smith, chief executive of the Consumer Council for Water, the independent body representing water customers, said: 'It's been the best process for the customer than any price review since privatising. Ofwat has been generous to the sector over several previous reviews.'

Thames Water customers are still expected to be hit during the period with additional price increases to pay for the building and financing costs of the Thames 'super-sewer', a £4.2-billion project designed to prevent regular overflows of untreated sewage into the capital's river. The cost of that project could eventually add £80 annually to Thames Water customer bills.

Source: adapted from © the *Financial Times* 12.12.2014, All Rights Reserved.

(a) Water companies in England and Wales are monopoly private sector suppliers of water and sewage services to households. Explain why they might need regulating.

(b) Ofwat fixes prices for households by allowing water companies to change their bills on an RPI plus or minus formula. Using the data, explain what this means.

(c) Why might water companies earn abnormal profit even though their prices are being regulated?

Question 1

In the United States, limits have been placed on profits of recently privatised utilities, relative to the value of their capital assets. What may be considered the biggest disadvantage of this method of regulation?

(1)

A Firms will undervalue their capital assets

B Quality may decline as the regulator forces costs down

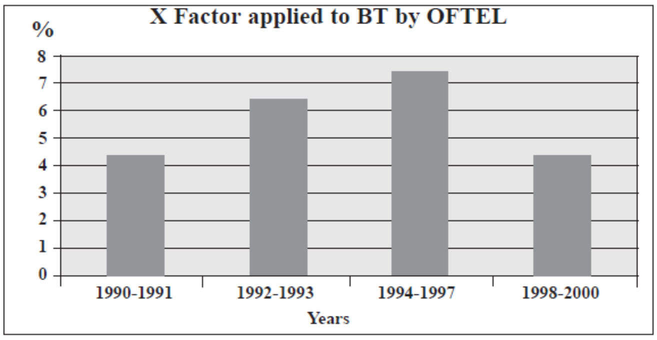
C The firm can make unlimited supernormal profits

D Firms have little incentive to become more productively efficient

E Firms are encouraged to make excess profits which they pay out as dividends to shareholders.

Answer ☐

Question 2



The graph shows the values of X applied by the industry regulator OFTEL when price capping telecommunications company BT, according to the *RPI minus X* formula.

Which of the following can be inferred from the graph?

A Throughout the period shown BT has been allowed by the regulator to make real price increases.

B Throughout the period OFTEL believed there was room for BT to make efficiency improvements.

C Throughout the period shown BT's profits have been taxed at annual rates greater than 4%.

D After the 1990-1991 capping period BT was allowed by the regulator to raise its prices by more than 4% in nominal terms.

E After the 1994-1997 capping period OFTEL allowed BT to raise its prices by more than 4%.

Question 3

Rail Fare Rises for 2006

Train company	Average price rise of season ticket (%)	Average price rise of cheap day return ticket (%)
Central Trains	3.9	4.4
Midland Mainline	3.9	6.0
Silverlink	3.9	6.1
Virgin West Coast	3.9	5.9
Retail Price Index (% change)	**2.9**	**2.9**

Source: *www.strategicrailauthority.org.uk*

The table shows rail fare increases for selected train operating companies in 2006. Season tickets are subject to price controls by the rail regulator according to the RPI + K formula, where K is +1%. However, cheap day return tickets are **not** subject to price controls. It can be inferred from the table that

A the value of K is greater than the rate of inflation

B removing price controls will protect the consumer surplus

C the real price of season tickets have decreased

D cheap day return tickets are more expensive than season tickets

E the permissible price increase of season tickets is above the rate of inflation

Government intervention to promote competition and contestability

3.6.1 c) Government intervention:

- Enhancing competition between firms through promotion of small business
- Deregulation
- Competitive tendering for government contracts
- Privatisation

Promotion of small business- why?

- Small and medium-sized businesses (SMEs) provide 60% of jobs and 50% of GDP in the UK
- Small firms are often more innovative
- New firms can challenge existing firms in an industry and so increase its competitiveness

How can the government help small businesses?

a. Lower rate of corporation tax
b. VAT relief for small businesses
c. Act as a guarantor for bank loans
d. Encourage public sector bodies to give business to small firms

Case study: The UK energy market

Dominated by the 'big 6' energy companies, the market operates as a typical oligopoly. There are significant barriers to entry making it hard for new firms to compete. One measure taken by the regulator to increase the possibility of new forms entering the market has been to insist that the Big 6 make wholesale supplies of gas and electricity, which they produce, available to other firms.

With high prices for gas and electricity and a reluctance of many consumers to switch suppliers, this had led to accusations of high prices and poor service for consumers.

Small energy companies have beaten the big six on customer service ratings for the fourth year in a row, according to consumer body Which?

ecotricity

Npower achieved the lowest score for the fourth year running with 35%, rated the worst for its complaint handling and customer service. Scottish Power achieved a slightly higher score (41%), below EDF Energy (49%), British Gas (49%), E.ON (50%) and SSE (50%).

Scottish Power and npower both fell well below the British industry average of 48%, while Spark Energy was the only smaller supplier to score as poorly as the big six with 50%.

Consumers ranked Ecotricity the best supplier with a score of 84%, closely followed by Good Energy (82%), Ebico (81%), Ovo Energy (80%), Utility Warehouse (76%) and Flow Energy (73%) – all smaller independent providers.

Which? executive director Richard Lloyd said: "The large energy firms, which dominate the market, need to up their game as millions of customers deserve better." The news comes the day after Ecotricity announced that it has reduced the price of gas for all its customers by 6.1%, providing the biggest recent cut in the industry. www.guardian.co.uk

Watch the video clip- what reforms are proposed? http://www.bbc.co.uk/news/business-26349814

Deregulation

• Deregulation: involves the removal of any previously imposed regulations that have adversely restricted competition and freedom of market activity.

• E.g. UK government has removed the protected legal monopoly status enjoyed by bus companies, airlines, Royal Mail (parcels) and commercial TV and radio companies, access to BTs distribution network of land lines has been given to competitors in the telecommunications industry, and private power companies have been allowed to rent the services of the national electricity and gas distribution grids

• Lowering barriers to entry: e.g. provide low cost finance for new entrants, or reduce government-imposed barriers to entry such as import restrictions, licensing requirements or legal requirements (e.g. employment law).

Case study: mail delivery.

For many years, the government-owned Royal Mail had a legal monopoly on delivering letters and parcels. The Royal Mail had a duty to deliver a letter anywhere in the UK, with no competition allowed.

Competition was allowed in parcels, then in 2006 any licensed operator is allowed to deliver letters and parcels to business and residential customers. In 2013 Royal Mail was privatized.

Advantages of Deregulation

- Increased competition acts as a spur to greater efficiency, leading to lower costs and prices for consumers.
- Government regulation often involves excessive costs of bureaucracy.

Disadvantages of Deregulation

- It can be difficult to create effective competition in an industry which is a natural monopoly – high barriers to entry. Deregulation may create a private firm with monopoly power.
- Deregulation could lead to a compromise of public services with poorer quality provision.

Deregulation of bus market

Economic theory suggests that competition will often lead to improved economic efficiency, with this logic supporting the moves made in the 1980s to deregulate much of the UK bus market. So it's disappointing to hear that 25 years later, the chairman of the Competition Commission's local bus market investigation group has announced that the "reality is that in too many areas of the country, competition has stagnated and the incumbent providers know that they face little in the way of serious challenge".

The Competition Commission went on to say that 'head-to-head competition is uncommon' in the UK's local bus market and that this has meant poorer services and higher fares for passengers.

There are 1,245 bus companies operating in England, Scotland and Wales, but just five of them: Arriva, FirstGroup, Go-Ahead, National Express and Stagecoach have such a large market share that they operate with a **concentration** ratio of 70%. The commission said the Office of Fair Trading should exercise "its discretion not to refer small mergers" of bus operators to the Competition Commission and Local Transport Authorities are being asked to consider "partnerships" with new operators to increase competition in their local areas.

Why has deregulation failed to deliver the "sustained competition" so that firms take on existing providers of bus services? Economic theory suggests that competitive pressure can even build up without new firms entering the market if it is **contestable**, or vulnerable to new competitors joining at any time.

The Competition Commission blamed "operator behaviour" for keeping rivals out, with some companies using short-term measures, such as suddenly increasing the frequency of their bus services, until a rival had left the market. The commission's report found that in one area, the north-east of England, it had seen "direct evidence" of bus firms avoiding "competition with each other in order to protect their own territories". It went on to recommend that bus firms will be banned from "over-bussing" and other short-term measures designed to keep out new rivals. They will also have to share bus stations with competitors and accept "multi-operator ticketing schemes". This move might have the extra benefit of helping to **integrate** transport services more effectively.

The Confederation of Passenger Transport UK (CPT), which represents bus companies, said it could not agree with all the commission's findings. The CPT chief executive has said that "the single biggest message to come out of this process is that, while measures need to be taken to further open up the market to competition, the current commercialised framework for delivering bus services is what serves the passenger best". A spokesman for bus operator Arriva added that they regretted that "the CC seems not to have taken this opportunity to address the impact of competition from private transport which is the main reason behind falling usage of what is a very **efficient** bus industry". In other words, the main source of competitive pressure on bus companies comes from other modes of transport.

Source: Bus market not competitive, Competition Commission says - BBC

1. To what extent has privatisation and de-regulation improved contestability and efficiency in the UK's local bus market?

2. Does the evidence suggest a need for new regulation as proposed by the Competition Commission?

Competitive tendering for government contracts

Some services are state provided or subsidised as they are merit or public goods- private sector provision is inadequate or inequitable. State financing of these goods/services does not require state production- the public sector could purchase them from private sector

Contracting out: getting private sector firms to produce the goods and services, which are then provided by the state for its citizens.

Competitive tendering: introducing competition amongst private sector firms, which put in bids for work, which is contracted out by the public sector.

Process:

- Government draws up specification for good/service.
- Invites private sector firms to bid for the contract to deliver it.
- The firm offering the lowest price, subject to quality guarantees, wins the contract.

e.g. http://www.serco.com/

Class discussion: Overall what might be the benefits and limitations/disadvantages of contracting out?

Advantages	Limitations/disadvantages

Whistle-blowers criticise privatised probation service

http://www.bbc.co.uk/news/uk-25035850

Watch the video clip of the BBC Newsnight 21st Nov 2013:

1. What criticisms are made of the contracting out of the management of community projects in London?

3. What did Serco say in response to the criticisms?

Can outsourcing probation services cut reoffending rates?

BBC news 18 Feb 2014

39 year old ex-offender Lee confesses that in order to feed the heroin addiction that has blighted his adult life he has burgled thousands of houses. He's been caught so many times that he's spent more than 20 years in prison. "It was a vicious cycle," he says. When he came out of jail, his drug use would "spiral", he would commit crimes, and then be arrested and imprisoned again. But over the past six months Lee has turned a corner.

'Measurable impact'

A face-to-face meeting with two householders whose homes he had broken into convinced him it was time to change. "I was sick of creating victims," he explains. With the help of probation he is trying to come off drugs and go straight. Peterborough Prison's rehabilitation model has been closely watched. But the government believes there are too many offenders like Lee - too many people stuck in a revolving door of crime, prison, crime, prison. So it is introducing radical reforms in an attempt to lower reoffending rates and cut the costs to the criminal justice system. The key plank of the reforms involves outsourcing the majority of probation work to private firms and voluntary groups. They will be awarded contracts to supervise low- and medium-risk offenders - there are currently about 160,000 across England and Wales. The successful bidders will receive a basic fee for monitoring offenders, which will be topped up if they meet targets to cut reoffending - an approach known as payment-by-results. It is similar to a scheme at Peterborough Prison in Cambridgeshire where, since September 2010, short-term prisoners have been given intensive supervision on release. Chris Grayling, the justice secretary, says Peterborough is having a "measurable impact" on reoffending rates and the number of crimes committed. Interim figures published by his department appear to support his view: reoffending rates among the Peterborough prisoners are falling, while among a national sample of offenders they are increasing. The justice secretary has placed an emphasis on monitoring short-term offenders. But Carol Hedderman, (criminologist, Leicester University), says the statistics do not compare like with like. "The bottom line is that these results don't tell you anything very much," says Prof Hedderman, who is part of an independent team commissioned by the Ministry of Justice to examine the Peterborough project. "Until we do our much more detailed and sophisticated analysis you won't know the answer to that question as to whether Peterborough has been a success or not," she says, adding that she has not yet seen any examples of effective payment-by-results schemes.

Appeals lodged

Napo, which represents more than 7,000 staff, is also concerned about the process for allocating probation officers to their roles in the new system. Some are being told they will be working for the outsourced organisations. Others will be employed by a new public body, the National Probation Service, which will deal with high-risk offenders including sex attackers and those convicted of serious violence. Napo says 553 probation officers from about half of the probation areas have lodged appeals against the roles they have been assigned - with 119 successful so far. Mr Grayling says the number of appeals is a "tiny fraction" of what he was expecting - but it is expected to increase significantly as more staff are told where they will be working. The changes have driven Joanna Hughes, (deputy chair Napo Gloucestershire), to quit probation after 16 years' service. She believes that dividing offender supervision between different bodies will lead to communication problems and make further offences more likely.

Pressing ahead

BBC File on 4 has learned that ten of the 33 most senior probation officials plan to leave when their probation trusts are abolished as part of the reforms. The Probation Chiefs Association says it represents a loss of "hundreds of years of experience". But the justice secretary is pressing ahead with the changes, due to be in place by April next year. Under his reforms, almost 50,000 adult offenders released from jail terms of under 12 months will be monitored on release. They are the group with the highest reoffending rates, but there is currently no legal requirement for them to be supervised. Mr Grayling says at last they will leave jail with more than just a cash discharge grant of £46. But if the reforms are to work, then more offenders like Lee, the heroin addict and repeat burglar, will have to be motivated and given the right help. "A lot of clients will stick their fingers up," says an unconvinced Lee. "They'd rather go to jail and sit in jail with a telly, three meals a day, than being out here, being on tag."

Private probation firms fail to cut rates of reoffending (Guardian Sat 3 Feb 2018)

The vast majority of companies set up to tackle reoffending as part of a controversial drive to privatise the probation service have failed to meet their targets, in a substantial embarrassment for the government. Dramatic official figures have revealed that only two of the 21 regional companies set up to oversee low and medium-risk offenders have managed to reduce the number of new offences committed by reoffenders.

The revelation comes amid claims that the probation system is in crisis. Senior figures in the service warn that the companies involved lack the resources to do the job, while staff shortages have already meant that some ex-offenders are supervised by telephone calls.

The failure emerges just weeks after the public spending watchdog, the National Audit Office, warned that the new "payment by results" system meant that a failure to hit reoffending targets could blow a further hole in the service's finances. The companies involved have already required an extra £340m.

It is another sign of the difficulties facing public services after years of public spending cuts. The supervision of offenders not deemed high-risk was handed to 21 community rehabilitation companies (CRCs) in 2014, as part of a privatisation drive by the former justice secretary Chris Grayling. Companies were to be partly paid in relation to their success in reducing reoffending.

However, official figures from the first year of the new system's operation reveal that, among the prisoners who went on to reoffend, the average number of crimes committed in 2015-16 went up in all but two areas compared with 2011. It means that only the companies operating in Merseyside and Northumbria met their targets and are in line to receive a full payout from the Ministry of Justice. The remaining 19 could have a portion of their income cut as a result of the "payment by results" system.

These results follow a devastating official report at the end of last year in which Dame Glenys Stacey, the chief inspector of probation, said there was "no clear evidence that payment by results linked to reoffending rates [had] made any difference to the life chances of these or others under probation supervision. "In those cases we inspected, only a handful of individuals had received any real help with housing, jobs or an addiction, let alone managing debt or getting back into education or training," she said. "What is more, about one in 10 people were released without a roof over their heads.

"CRCs are too often doing little more than signposting and form-filling. Apart from Wales and Durham CRCs, we find that CRCs we have inspected are making little material difference to the prospects of individuals upon release, and yet this work is so important in breaking the cycle of offending."

Andrew Neilson, director of campaigns at the Howard League for Penal Reform, said the data revealed significant flaws in the privatised service. "The rhetoric at the time of the privatisation was all about payment by results and improving the fight against reoffending," he said. "But that was really just a smokescreen for something that was about cutting costs and taking money out of the system.

"When you put these figures alongside Glenys Stacey's report, it is impossible to avoid the conclusion that this was about taking money out. When you boil it down, this is a service where companies are failing and being paid to fail because of a botched privatisation."

The Ministry of Justice said that there were now fewer offenders overall and that those who remained in the criminal justice system were more prolific offenders – which explained why the numbers of new offences per reoffender were increasing. "Our probation reforms mean we are monitoring 40,000 offenders who would previously have been released with no supervision," a spokesperson said. "Overall, community rehabilitation companies have reduced the number of people reoffending, but they need to do more to ensure we have a service that keeps the public safe and helps offenders turn their back on crime.

"Probation officers are doing an incredibly professional job, and we will continue to work closely with CRCs to improve performance."

The department also said that those companies that had failed to meet targets would face deductions in their fees.

Identify arguments for and against outsourcing of probation services

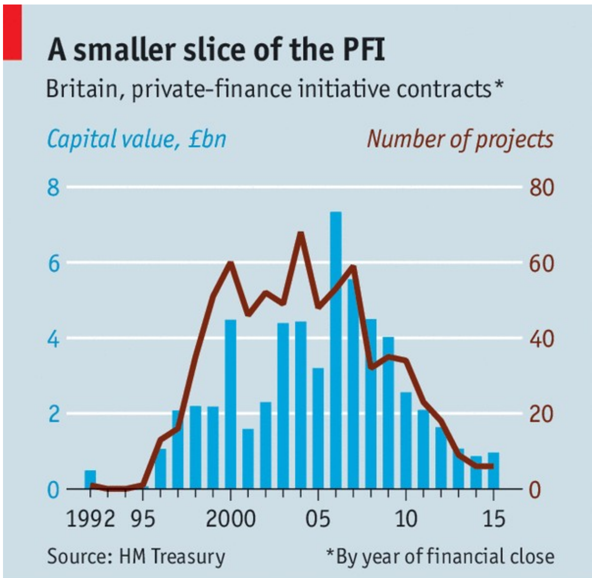
Arguments for	**Arguments against**

Public Private Partnerships (PPPs)

Public Private Partnerships (PPPs): a partnership between the public sector and the private sector where the public sector and private sector companies collaborate to deliver services.

- One type is **partial privatisation** where state retains a part share (e.g. NATS)
- Most common form in recent years has been PFI projects (**Private Finance Initiative**)- a private sector firm finances a project e.g. a bridge and collects income for a fixed period of time (toll), or government leases the facility from the private company on a long lease (e.g. hospital).
-

PFI was introduced in 1992 with the Aim of increasing the involvement of the private sector in public sector provision. Under its most common form, a private sector firm would design, build, finance and operate facilities based on 'output' specifications decided by public sector managers and their departments. The private sector has always been involved in building most public facilities but PFI also enables the design, financing and operation of public services to be carried out by the private sector. Under PFI the public sector does not own an asset such as a school or hospital but pays the PFI contractor a stream of committed payments for the use of the facilities over the contract period. Once the contract has expired, ownership of the asset either remains with the contractor or is returned to the public sector, depending on the contract.
PFI has continued under all governments until now. Its drawbacks have now become more evident.



Economist.com

This arrangement enabled the government to gain many new public sector facilities without 'up-front payment' and therefore avoided the need for increasing taxes or borrowing. However, it has increased the cost to current and future generations, with private sector firms gaining significant profits at the expense of the NHS and other users of the projects.

The number of projects has declined with a return to more conventional forms of contracting.

Examples of Private Finance Initiative (PFI) projects

PFI: An introduction

http://www.youtube.com/watch?v=g2W_HuokgFE

ITV Meridian: PFI

http://www.youtube.com/watch?v=mlKbpzlrV9g

A costly shambles: The Regional Fire Control Centre, Taunton

http://www.youtube.com/watch?v=i0G_sRz5cSA

Bristol hospital

http://www.youtube.com/watch?v=4wrx5Q1etr8

Privatisation

Table 1 Sale of state owned companies to the private sector

Date begun			
1979	*British Petroleum	1987	British Airways
	*ICL		Rolls Royce
	*Ferranti		Leyland Bus
	Fairey		Leyland Truck
1981	British Aerospace		Royal Ordnance
	*British Sugar		British Airport Authority
	Cable and Wireless	1988	British Steel
	Amersham International		British Leyland
1982	National Freight Corporation	1989	Water Boards
	Britoil	1990	Electricity Area Boards
1983	*Associated British Ports	1991	Electricity Generation
	British Rail Hotels	1994	British Coal
1984	British Gas Onshore Oil	1995	British Rail
	Enterprise Oil	1996	British Energy
	Sealink Ferries	1999	National Air Traffic Services
	Jaguar Cars	2000+	British Nuclear Fuels
	British Telecom	2002	Network Rail renationalised
	British Technology Group	2004	British Energy renationalised
1986	British Gas		

*Partly owned by government at the time of sale.

Arguments in favour of privatisation

- Promotion of **competition**
- **Cost (productive efficiency):** reduce X-inefficiency
- **Choice and quality**
- **Innovation** (dynamic efficiency)
- **The invisible hand of the market** (resource allocation)

The process of privatisation can achieve:

- **Wider share ownership** "Popular capitalism"
- **Reduction in public borrowing and state spending**

Class discussion: What might be the disadvantages of privatisation

Royal Mail privatisation

Extract 1

The government and Royal Mail management say the company needs access to private capital in order to grow and compete. They argue that the boom in internet shopping means parcel delivery is far more important to Royal Mail's business than the delivery of letters, which is shrinking, and they need investment to revamp the business accordingly. The government is also reluctant to invest large sums of money itself at a time when it is trying to cut public spending and borrowing. Privatisation has been planned for many years, with legislation enacted in 2011 to pave the way for the sale. Royal Mail is also facing competition from private operators such as TNT and UK Mail, following the opening up of the market in 2006.

BBC News 7 October 2013

Extract 2

Taxpayers lost out on £1bn because the government and its City advisers underpriced the privatisation of Royal Mail, a committee of MPs says today. In a highly critical report, the Business, Innovation and Skills (Bis) committee said the government worried too much about pushing the privatisation through at the expense of getting the best price for taxpayers.

Royal Mail was privatised in October when the government sold 60% of its stake at 330p a share, valuing the company at £3.3bn. On their first day of trading, the shares jumped by 38% – far higher than normal for a flotation – and continued to rise after that. They hit a high of 615p on 15 January and closed at 474p on Thursday, valuing Royal Mail at £1.4bn more than the sale price.

Cable dismissed the post-privatisation rise in Royal Mail's share price at the time as "froth" that would settle once the market had judged the company's value. The committee criticised Cable for not defining froth properly and for stretching the period he had in mind from the "immediate aftermath" of the flotation to months or years later.

Adrian Bailey, chairman of the committee, said: "It's not at all clear that the government's sale of Royal Mail has brought an adequate and appropriate return for taxpayers. The government cannot blithely dismiss as 'froth' our committee's concern that the low issue price of this prime public asset has cost the taxpayer around a billion pounds."

Cable's department said the privatisation raised £2bn for taxpayers and put Royal Mail on a secure footing as a publicly traded company able to raise capital from the market. It said the report ignored the size of the share sale and included factual errors.

Guardian 11.7.2014

Advantages of Royal Mail privatisation	Disadvantages of Royal Mail privatisation

Government intervention to protect suppliers and employees

3.6.1 d) Government intervention

- restrictions on monopsony power of firms
- nationalisation

Restrictions on monopsony power of firms

The UK grocery market has been the subject of two major inquiries in recent years. In October 2000 the Competition Commission completed the first of these enquiries, and it lead to the creation of a Code of Practice, to regulate the relationship between the largest supermarkets and their suppliers. However, the OFT received many complaints that the Code was not preventing supermarkets exploiting some of their suppliers, and putting many small shops out of business. In May 2006 the OFT referred the market to the Commission for a second time. In April 2008 the Commission completed its inquiry, concluding that in many respects UK grocery retailers were “delivering a good deal for consumers” but that action was “needed to improve competition in local markets and to address relationships between retailers and their suppliers”, including a strengthened and revised Code of Practice, to be enforced by an independent ombudsman. *Parliament.UK*

Why do supermarkets have monopsony power over their suppliers?

Evaluate the likely success of a voluntary code of practice for supermarkets?

Nationalisation

Nationalisation: the transfer of firms or assets from private sector ownership to state ownership. Nationalised industries and public corporations: state owned industries or companies.

- Private monopoly is assumed to maximise profit, this leads to an inefficient leve
- Nationalisation aims to change the goals of the firm, the industry then asked to social welfare not private profit.

https://www.youtube.com/watch?v=ysdp-Zj5spo

Arguments in favour of nationalisation

- **Lower costs** (productive efficiency) from economies of scale by merging numerous previously private businesses (e.g. railways) if natural monopoly, also no marketing costs.
- **Better management**: viewed as opportunity to appoint efficient modern management to run industries to maximise net social benefit. It is argued previous private owners sought quiet life or short run profit.
- **Control of monopolies**: easy and efficient way of controlling local monopolies (e.g. railways or gas supplier).
- **Maximising of net social benefit not private profit**: where externalities argued to be present, e.g. coal mines damaging workers health.
- **Greater control of economy**: for government to manage unstable market economy, i.e. move towards planned economy.
- **Fairer distribution of resources**: from owners to workers / consumers.

Class discussion: What might be the disadvantages of nationalisation?

See tutor2u revision presentation at http://www.tutor2u.net/economics/reference/nationalisation

Arguments for and against renationalisation of railways

Background (BBC)

Britain's rail network was first nationalised by Labour Prime Minister Clement Attlee in 1948 and then privatised again under Sir John Major's Conservatives in 1993. Now, 24 years on, Labour says our railways have become inefficient and expensive; it wants to see a return to public ownership. Labour's pledge appears to resonate with the public. Two years ago, a YouGov poll suggested half of voters would prefer trains to be run by the public sector, while one in four favoured private ownership.

Since privatisation, the number of passenger journeys have increased from 735 million in 1994-95 to 1.7 billion in 2015-16, according to the Office of Rail and Road. Under the existing system, Britain's railway lines are run by train operating companies as franchises for a fixed length of time. There are currently 18 franchises in England, Scotland and Wales.

With the odd exception, the shortest contracts run for seven years, although 10 years is more common. Northern Ireland's rail system has remained nationalised since 1948. The train operating companies are not responsible for track maintenance, this falls to Network Rail, which is publicly owned.

The government also pays subsidies to the rail industry of more than £3bn a year, of which £0.6bn goes to the franchised train operating companies. Subsidies might be needed to deliver services in areas that would otherwise not be commercially viable, such as some rural communities.

Would nationalised trains be better? (Channel 4, May 2017)

A nationalised system would have public sector rules on transparency and accountability, and would give the government more control over certain areas. But the quality of the service depends largely on the level of investment and how it's run. The best case study we can look at is East Coast rail. The service was rescued by a government-controlled company in 2009, after National Express fell into financial trouble and the franchise collapsed. It was handed back to the private sector in 2015, but the experiment had undoubtedly been a success. Under public ownership, satisfaction rates climbed to 91 per cent – the joint top score for a franchised long distance operator. In its final year of service, it provided £225m to the Department for Transport, saw ticket sales rise, and made a pre-tax profit of £8.4m.

But this was just a single service for a few years. Expanding it nationwide would be a much bigger challenge. Before privatisation, British Rail was criticised by some for being monolithic, costly and inefficient. Passenger numbers fell for years until private companies came in – usage is now at an all-time high. But this may not be a very useful comparison because so many other factors have changed since then, such as better technology, the levelling off of average car usage and sustained public investment from Network Rail.

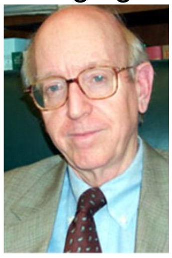
Figures suggest some train fares have gone up dramatically. There's not a lot of good comparative data on this, prior to privatisation. However, the Rail Fares Index shows fares have gone up by an average of 121.3 per cent between 1995 and 2017, with long distance fares increasing the most. Another study in 2013 showed that certain London to Manchester tickets had risen 208 per cent since privatisation – three times the rate of inflation (RPI) – although there was a lot of variation between different types of tickets.

On train punctuality, there are no directly comparable figures showing the effect of privatisation, but the overall trend seems to be positive. A review in 2001 suggested that punctuality had increased, until the Hatfield train crash in 2000, when the trend briefly reversed to pre-privatisation levels. Figures dating from 2002, collected by Network

Rail, show punctuality has “risen dramatically” since then. Again, it’s difficult to say how much credit private companies should get for this. Public investment, improvements in technology and natural industry development are also factors to consider. But whatever the pros and cons of nationalisation, many rail problems are unrelated. The Telegraph has pointed out: “Overcrowding on many routes as become a problem, but this is largely down to Victorian infrastructure rather than any fault of the private operators. If British Rail was around now it would be facing exactly the same problems.”

3.6.2 b) Limitations to government intervention

Regulatory capture is a situation in which the regulator of an industry ends up acting for the firm rather than regulating it and acting in the interest of consumers.
This means that groups such as monopolists earning abnormal profit or polluters damaging the environment can strongly influence the way they are being regulated to their own advantage



- Concept first used by Chicago economist Richard Posner:
- 'Gamekeeper (regulator) turns poacher (regulated body), or at least helps poacher...' 'Regulation is not in the public interest at all...' 'Regulatory agencies come to be dominated by the industries regulated...'
- **Example of regulatory capture- OFLOT**
- 1998, Peter Davies, the Lottery regulator was found to have accepted free flights from GTech, who had a 22.5% stake in Camelot.
- Camelot won the right to run the UK National Lottery over Richard Branson's proposed lottery company. It was Branson who alerted the authorities! GTech allegedly tried to bribe Branson to pull out of the bid.
- 1999 OFLOT replaced by **The National Lottery Commission**

What qualities make a good regulator? How should they be appointed?

Posner argued that regulation was **NOT** in the public interest at all. It is a process by which interest groups are able to promote their own interests. He claimed that regulatory agencies come to be **dominated by the industries being regulated** over time.

This is an extreme view. Other economists would agree that regulators are **at risk** of being dominated by their industries but do not necessarily always get ‘captured’.

In a typical regulated industry, such as most utilities, there is a small number of large firms which are regulated to benefit a large number of consumers. Each firm's profits are heavily influenced by regulation, so they will each put a lot of effort into influencing the regulator.

Conflicts of interest among individuals who run the regulator may also lead to regulatory capture. It is not uncommon for people to move between working for the regulator and working for the industry: for example working for a financial regulator and then in a compliance role in a bank.

Example

HMRC’s failure to collect tax from large corporations- is this regulatory capture?
The Public Accounts Committee has said that HM Revenue and Customs enjoyed an “unduly cosy” relationship with major companies, and their procedures have allowed rules to be ‘bent’ so that up to £25bn tax has been underpaid (tutor2u.net)

Goldman Sachs tax deal faces UK legal challenge (bbc.co.uk 22.12.11)
UK Uncut has begun legal proceedings to force banking giant Goldman Sachs to pay more to the UK tax authorities. The pressure group requested a judicial review into a decision by HM Revenue & Customs (HMRC) that let the bank off paying interest on its tax bill. The shortfall, which HMRC told MPs this week was an error, was estimated by the National Audit Office to be £5m to £8m. However, a whistleblower who worked for HMRC estimated the cost at £20m - a claim that has been rejected by HMRC.

The idea that regulatory bodies will correct market failures and operate in the interests of society follows **public interest theory.**

Public interest theory is an economic theory first developed by Pigou that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. Regulation is assumed to benefit society as a whole rather than particular vested interests. The regulatory body is considered to represent the interest of the society in which it operates rather than the private interests of the regulators.

However, the likelihood of **regulatory capture** provides support for **public choice theory**

Public choice theory
This studies the decision- making behaviour of voters, politicians and government officials. It was first developed by Buchanan and Tullock to explain how decisions are made. Government intervention may not be aiming to maximise social welfare. It may be aimed at maximising votes or furthering the interests of certain interest groups. Therefore, government attempts to 'fix things' may do more harm than good. Economists have realized that it is naive to assume that market failures will automatically be corrected by the creation of a body or organization to tackle the problem. In such situations the outcome does not improve social welfare but leads to a misallocation of resources i.e. government failure.

Extract from an article in FT.com by John Kay, December 2010

Corruption can be more subtle. A politician who looks to a life after politics knows that big companies can offer lucrative consultancies and directorships, but representing the public interest does not. Everyone who works in a regulatory agency knows that if they are well regarded in the industry, they are eligible for jobs in the private sector that are often more rewarding than employment in a public agency.

But the most common form of capture is honest and may be characterised as intellectual capture. Every regulatory agency is dependent for information on the businesses it regulates. Many of the people who run regulated companies are agreeable, committed individuals who are properly affronted by any suggestion that their activities do not serve the public good. Few members of the public, by contrast, ever make contact with a regulatory agency; almost always, they are less well informed than the professionals who deal with regulatory issues. It requires a considerable effort of imagination to visualise that any industry might be organised very differently from the way that industry is organised now. So even the regulator with the best intentions comes to see issues in much the same way as the corporate officers he deals with every day. You require both an abrasive personality and considerable intellectual curiosity to do the job in any other way. And these are not the qualities often sought, or found, in regulators.

Asymmetric information

Private Water Companies make £1 bn from unnecessarily high prices (Independent, 13/1/16)

A report from Parliament's Public Accounts Committee has accused OFWAT, the water regulator, of "consistently overestimating" water companies' financing and tax costs when setting price limits. As a result, water companies made gains of at least £1.2 bn over the past five years from bills being significantly higher than necessary. Amongst the worst hit were poorer customers, with average water bills now representing 5.3 per cent of their annual income, compared with 2.3 per cent before the recession.

Over the past five years, shares in some of Britain's privatised water companies have surged by 50% over a period when the stock market as a whole has barely increased in value. At the same time consumer bills have risen every year on average by 0.5 % above inflation with customers paying £396 a year for water and sewage.

The committee found that OFWAT had been unduly generous to companies in the assessments that it had made about the cost of borrowing, corporation tax and investment over the past five years – and now had no way of clawing the money back.

But Cathryn Ross, OFWAT's chief executive, insisted that "holding companies to account" was at the "heart of what we do". "The PAC comments on gains relate to decisions OFWAT made six years ago. Since, 2012, we've stressed that customers are having a really rough time, and stepped in to claw back £435 m from companies. "We then challenged companies to reduce bills further, resulting in £3 bn of savings, which mean bills fall 5% in real terms over the next 5 years. Service will continue to improve and we have kept bills below inflation over 2 decades."

1. To what extent have OFWAT been successful in regulating the water industry?

2. What is meant by: a) Asymmetric information b) Regulatory capture?

3. Is there any evidence of asymmetric information or regulatory capture in the above extract?

BT rallies forces for battle of Openreach

The Sunday Times, 21/2/16

Patchy coverage and sloth-like download speeds have long exasperated businesses and consumers outside densely populated areas. This is despite the government spending £1.7 bn on delivering broadband to remote areas – the bulk of which has gone to BT.

Ofcom is due to set out radical proposals to reshape the industry. The nuclear option is a break-up of BT, splitting off Openreach, the BT division that owns the copper and fibre-optic lines that connect most homes and businesses to the internet.

Rivals, such as TalkTalk and Sky, which depend on Openreach to deliver broadband to their customers, argue that a carve-up would be the best way to create a more dynamic and competitive industry, and improve service levels to consumers. Dido Harding, the boss of TalkTalk said “Customers of Openreach feel very let down, and the most depressing thing is that BT keeps insisting that everything is OK.” Competitors say there is an inherent conflict of interest in BT owning the broadband infrastructure and also being the largest consumer internet business. They liken it to British Airways owning Heathrow. Another concern is BT’s recent £12.5 bn takeover of the mobile operator EE, which has further strengthened its position.

But Mark Shurmer, head of regulatory affairs at BT argues “Our regulatory model and the outcome it produces for consumers are the envy of the world. BT has the lowest retail market share of any incumbent operator anywhere in the world.” According to Ofcom, Britain is doing well, compared to other European countries, in rolling out fast broadband.

But according to a House of Lords committee, London last year ranked just 26th amongst European capitals for broadband speeds, just ahead of Minsk in Belarus. BT is laying fibre-optic cables for super-fast broadband, but only as far as pavement cabinets, then the internet is carried into homes and businesses on copper wires which are decades old. Half of small businesses on business parks have download speeds less than 10 megabits per second, the minimum the government has promised to all users by 2020.

Andrew Griffiths, Chief Financial Officer of Sky, argues that investment would improve if Openreach was separated from BT, to become a FTSE 100 company in its own right, able to attract shareholders looking for a steady return.” As a stand-alone company Openreach would be highly attractive to investors and be able to raise capital for future growth”.

Shurmer at BT said extending the fibre to every home and business would be “very expensive and require huge public subsidies” and was “not necessary”, as BT’s G.fast technology will deliver big increases in network speed.

A split of BT and Openreach would be time-consuming, requiring a review by the Competition and Markets Authority, which would take 18 months to 2 years to complete. Sharon White, CEO of Ofcom, fears that during that period of uncertainty, BT would cut investment in Openreach. She is therefore not expected to break up BT, but instead beef-up service-level commitments and provide tougher safeguards to ensure that competitors such as Sky and TalkTalk are treated the same as BT’s consumer arm.

1. To what extent is BT Openreach providing a good quality of service to internet users?

2. Is there any evidence of x-inefficiency in BT Openreach?

3. To what extent is there evidence of regulatory capture?

4. Discuss whether Openreach should be split from BT to form a separate company:

Advantages of splitting Openreach from BT to form a separate company	Evaluation: Disadvantages/limitations/success depends on…

Overall evaluation of regulation

Class discussion: Overall, what are the benefits and limitations of regulation?

Benefits	Limitations