1

Introduction

Ever tried. Ever failed. No matter. Try again. Fail again. Fail better.

Samuel Beckett, *Worstward Ho* (1983)

Market-based economies are ubiquitous throughout the world. Whether motivated by ideology, experience or the discipline of economics, there is a general – though not universal – acceptance of the market mechanism as an integral element in the organisation of society. Adam Smith's striking vision of 'the invisible hand of the market'[1] underlines a widely accepted tenet of the functioning of market systems: namely, that markets work best when unencumbered by government intervention. Yet history, both distant and recent, tells us that neither markets nor economists are infallible in this respect. The well-functioning market, bringing the wealth of society to its highest and best uses, may be a thing of beauty in the abstract realms of economic theory. Quite disobligingly, however, real-life markets often fail to live up to the promise of their impeccable archetype. Governments thus not infrequently intervene in dysfunctional markets in order to correct persistent market failures or to advance alternative non-economic goals. Competition law and economic regulation are both components of the State's arsenal of market regulatory tools that facilitate the legal function of market regulation – what one might, somewhat cynically, describe as the task of enabling markets to 'fail better'. The operation of and interactions between these legal instruments comprises the subject of this work.

Markets are everywhere, and increasingly so. Particularly with respect to the State-owned enterprise and regulated monopoly sectors, 'privatisation' and 'liberalisation' have been (somewhat loaded) buzzwords for decades. As we will discuss in Chapter 3, the latter half of the twentieth

[1] Smith (1776:293).

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century witnessed a prolonged attack against the perceived inefficiencies of much existing economic and social regulation, which led to a notable paring back of purported regulatory burdens. This politically motivated embrace of a purer form of free markets has led to decidedly mixed results. Few would dispute that certain market-based reforms have been largely beneficial; think, for example, of deregulation of the cossetted airline industry, which brought about a dramatic reduction in airfares and has made air travel possible for a much broader section of society. Other developments are more controversial, particularly those involving the marketisation of public-service provision; recent efforts to partially 'privatise' the UK's National Health Service provide a clear example in this regard.[2] The Global Financial Crisis offers a trite but still potent example of how markets can go very badly wrong, and the negative consequences – both economic and social – that may follow. The phenomenon of globalisation has, amongst other things, led to the emergence of a globalised marketplace, and encouraged the broader adoption of market-based principles in many developing economies. Frustration with unthinking 'market fundamentalism'[3] has led to a backlash in many areas, however: from prominent anti-globalisation protests in Seattle and London, for example; to the (still largely untapped) vigour of the Occupy movement; to increasing disillusionment with and rejection of the so-called 'Washington Consensus' by developing nations.[4] Rising levels of inequality, in particular, provide an increasingly urgent rebuke to the ascendancy of markets-focused thinking.[5] Generally, it might also be said that there is a growing realisation, to quote Cass Sunstein, that 'markets should be understood as a legal construct to be evaluated on the basis of whether they promote human interests, rather than as a part of nature and the natural order, or as a simple way of promoting voluntary interactions'.[6]

The very concept of 'free' markets is, to an extent, a fallacy – what Sunstein calls the 'myth of *laissez-faire*'.[7] While this idea may appeal to notions of autonomy and freedom from State oppression, all markets depend, to a degree, on law for their existence and operation. It is essentially impossible to think of any market that does not, in some way, rely upon legal rules that regulate, for example, contracts, tort or criminal penalties (for instance, controlling financial crimes such as

[2] See the Health and Social Care Act 2012.
[3] The phrase is most closely associated with the work of economist Joseph Stiglitz.
[4] Williamson (1990). [5] Piketty (2014). [6] Sunstein (1997:5). [7] Ibid.

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fraud). Thus, the 'invisible hand' is both facilitated and constrained by law, even in markets that look, at first glance, to be wholly unencumbered by regulation. Moreover, it is naïve to view State involvement solely as an obstacle to the operation of markets; put simply, markets don't always work well in practice. The operation of the market mechanism may be hampered in a way that means it produces, ultimately, a sub-optimal distribution; or the market itself may work fine, but it produces an outcome that, although efficient, seems deeply unfair. In such circumstances, there is likely to be a *prima facie* case for government intervention in the wider public interest. The stated mission of the UK's former competition authority, the Office of Fair Trading, comes to mind at this juncture: namely, 'to make markets work well for consumers'.

At a very general level, therefore, this book concerns the means by which law intervenes in markets to secure a better outcome for society. The potential breadth of this formulation is readily apparent, however, and even a cursory consideration of this topic in full would fill many volumes. Instead, this study focuses upon two particular instruments for State market supervision, competition law and economic regulation, considering the uses of and interface between these legal tools. Our focus is thus upon economic problems of a more micro-than macro-economic nature. In brief, competition law seeks to strengthen the workings of the market mechanism by prohibiting certain forms of anticompetitive behaviour by firms that, alone or acting in concert, have the ability to exercise market power. Economic regulation, as the concept is conceived for our purposes, generally involves a State-directed, positive, coercive alteration of or derogation from the operation of the free market in a particular sector, typically undertaken in order to address market failure, to be distinguished from regulation that pursues a predominantly 'social' aim. In essence, this conception of regulation involves an overreaching of the market mechanism, whereas competition law seeks to reinforce its operation. Our enquiry is premised upon the starting assumption that competition law and economic regulation are, in large part, separate mechanisms for market supervision, but that these instruments have overlapping scopes of application, so that, in practice, there can be considerable substantive interaction between these legal tools. Consequently, although competition law and economic regulation may comprise discrete mechanisms, there is no clear and absolute distinction between them; instead, this relationship is more intricate and multifaceted. The aim of this work is, broadly, to unpick and analyse the complexities of this relationship at a substantive level.

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The question of the interface between competition law and regulation has become increasingly pertinent, and increasingly pressing, as the liberalisation of former monopoly industries has created markets where partial regulation coexists alongside competitive segments. The apparent transatlantic division over approaches to the vexed question of concurrent application of competition law in regulated sectors – compare the decision of the US Supreme Court in *Trinko* to the holding of the Court of Justice of the European Union (CJEU) in *Deutsche Telekom*,[8] both considered in Chapter 4 – provides perhaps the clearest example of on-going controversy over this question. There are numerous additional dimensions to this relationship, nonetheless, each of which presents challenging legal and policy questions. Can or should competition law be used as a form of quasi-regulation, for example to control exploitative behaviour or fill gaps in a regulatory framework, an issue that is explored in Chapter 2? Given the persistent criticisms advanced by advocates of deregulation, considered in Chapter 3, why and when would regulation be the preferred mechanism by which to control anticompetitive firm behaviour? Moreover, while we focus on the substantive legal interactions between competition law and regulation that might arise, there are certain related, and problematic, institutional matters that must be must be considered, specifically concerning the division of labour between competition authorities and regulators. These questions are explored in Chapter 5. These analyses of overlaps in practice are complemented by a more abstract consideration, in the remainder of this chapter, of the concepts of competition law and economic regulation, both individually and in comparison. In the overarching treatment of these interrelated issues, the objective here is to produce a taxonomy of sorts that probes the actual and potential functional overlaps between competition law and economic regulation, and thus allows for a cohesive description of this interface as a whole.[9]

This book is not unique in addressing the relationship between competition law and economic regulation; generally speaking, however, existing work has considered the relationship only with respect to a specific regulatory regime – for example, the interface between competition law and telecommunications or energy regulation – or in relation to

[8] *Verizon Communications, Inc.* v. *Law Office of Curtis V. Trinko*, 540 US 398 (2004), and Case C-280/08 P *Deutsche Telekom AG* v. *Commission*, EU:C:2010:603.

[9] For discussion of the roles and benefits of taxonomy in law, see, e.g., Sherwin (2005) and Low (2009).

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one facet of the interface – for example, the problem of concurrency, or the application of competition law as quasi-regulation. The aim here, instead, is to develop a more objective, systematic and holistic exposition and analysis of the interface between these legal instruments, with a particular focus on substantive rather than procedural interactions. Having first clarified and classified the various interactions that may arise, this book will, moreover, engage in a normative exercise aimed at demonstrating the policy implications of a State's market intervention choices. We do not purport to provide a definitive answer to all interface conflicts that may arise, or even, in many instances, to advocate any preference between competition law and regulatory approaches to market supervision. The very existence of competition law or economic regulation within a system indeed reflects policy choices of some variety, and inevitably involves trade-offs, thus requiring political rather than purely legal decision-making. Moreover, the precise requirements and market effects of any scheme of economic regulation, and to a lesser extent antitrust, which condition the relationship between these legal instruments, can vary considerably from sector to sector and between jurisdictions, thus limiting the utility of any 'broad brushstroke' assessment of these issues.[10] Nonetheless, the detailed exposition and analysis provided in this work allows for the identification of recurrent themes and issues of potential concern. Our aim is, ultimately, to undertake the more modest task of assisting in the identification of socially beneficial market regulatory policies, and, furthermore, to understand the full implications of such policy choices.

This is not a politically charged work: it neither advocates for nor against a greater or lesser place for markets in societal organisation. It does, however, sound a sceptical note regarding the power and benefits of unbounded markets, recommending, amongst other things, that where the untamed operation of the market mechanism would work against the public interest, States should not be reluctant to constrain or even replace the market. In this regard, although a predominant focus of this book is the role for competition law, it differs from many other works on this topic insofar as it proposes a more direct acknowledgement of the benefits, and often the necessity, of more traditional forms of economic regulation (in contradistinction to competition law) to address certain market defects.

[10] O'Donoghue & Padilla (2013:45).

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I. Market failure and the pursuit of efficiency

We begin by examining competition law and economic regulation, separately, as legal instruments for market supervision. The primary purpose of both is, as noted, to address weaknesses (howsoever these may be conceived) within the market system. It is necessary, therefore, to consider the functioning of the market mechanism prior to any assessment of the mechanics of these legal instruments. Neoclassical economic theory – which is not without its critics, it will be acknowledged – posits that free markets are the engines of progress and function as efficient allocators of resources.[11] The free-functioning of the market thus puts the resources of society to the 'best' (i.e., most efficient) uses – Smith's 'invisible hand'.[12] Consequently, the State should, where possible, abstain from direct market intervention.[13] Yet, embracing a free-market model does not require that a State abstain entirely from market intervention. In particular, the persistence of market failures – or market absences, where no effective market exists – creates a need for State corrective action, for example through competition law or regulatory instruments.[14]

The ascendency of market-based economics, with its preference for free markets over central planning, is evident in practice throughout the contemporary developed world. Yet the robustness of the neoclassical approach has been challenged more recently by, amongst other things, developments in behavioural economics,[15] while the effects of the Global Financial Crisis have emphasised again the inadequacy of this model, particularly at a macro-economic level, in accounting for recurrent economic crises.[16] Thus, its teachings are now viewed rather more sceptically, at least outside the academy.[17] Nonetheless, neoclassical thinking about markets remains at the forefront of regulatory policy-making. We shall, accordingly, take its conventional explanations of how markets work, and how they fail, as the departure point for our broader discussion of the relationship between the market-supervisory instruments of competition law and regulation. This discussion comes with an acknowledged 'health warning' – these theories are not infallible, and may indeed fail to reflect important real-world concerns – as well

[11] Scherer (2008:31); Majone (1996:28); McKie (1970:6). [12] Smith (1776:293).
[13] Coase (1960). [14] Baldwin et al. (2011:15).
[15] See, e.g., Sunstein (2000); Reeve & Stucke (2011); Armstrong & Steffen (2011).
[16] See, e.g., Posner (2009); Stiglitz (2010); Mixon (2010); Sandel (2012).
[17] See, e.g., Colander et al. (2009).

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as a disclaimer that the choice of market theory in this instance is pragmatic rather than ideological. Efforts will be made throughout to highlight limitations within the existing model, in particular relating to its emphasis on *efficiency* in a world where *equity* is an equally compelling consideration. Moreover, a central idea within this book is the unavoidable need for State supervision of market functioning in many circumstances; the more complex question is how best this can be achieved.

In essence, within a market system firms produce products. The channels by which products reach purchasers constitute the market.[18] Market theory assumes that firms attempt to maximise profits, and, in doing so, select factor combinations for production that minimise total costs, as well as output levels that maximise net revenue.[19] Each individual firm stands in a relationship of rivalry to other firms, which conditions the actions of each; this setting comprises the industry in which firms operate. The prices that a firm achieves for its products are determined by supply and demand, which dictates market structure.[20] Generally, demand for a product increases as price falls, while supply increases as prices rise. The Keynesian notion of 'effective demand' links creation of demand, at the *micro*economic level, to a strong role for the State in maintaining *macro*economic stability, through full employment and stimulation of investment. The market-equilibrium price is then determined by the interaction of supply and demand on a commodity within a competitive market. This is, in theory, the 'market-clearing' price, namely the price for each good at which consumer demand is fully satisfied and supply exhausted.[21]

Market theory indicates that this market-clearing process achieves the most efficient allocation of society's resources. As each individual seeks to maximise his or her own utility, in aggregate the sum of total welfare reaches its highest value.[22] Efficiency, or wealth maximisation,

[18] Generally, Coase (1937); Clark (1961). [19] Samuelson (1983:8); Gelhorn (1975:6).

[20] Carstensen (1983:493–7). The concept of demand measures the desire of consumers to purchase a product at each of several different alternative price levels, while supply measures the quantities of a product that producers are willing to offer for sale at different price levels.

[21] Gelhorn (1975:7–22); Vickers (1995:1).

[22] Smith (1776:293); Williamson (1977:722). At a technical level, competitive markets are assumed to satisfy the requirements of Pareto efficiency, whereby there is no more efficient allocation of resources that can be achieved without making some individual worse off: Bator (1958:351).

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is the standard concept used in economics to measure an industry's performance of its economic task in society's interests.[23] Efficiency, in this context, comprises two aspects that are not wholly complementary.[24] *Static efficiency* concerns the allocation of resources with a given state of technology; it is a measure of total surplus, meaning consumer surplus (the difference between the consumer's valuation of the good and the effective price he pays for it) and producer surplus (the sum of all profits made by producers in the industry).[25] Static efficiency has two components: allocative efficiency involves matching production to consumer demand, while productive efficiency measures avoidance of wastage of resources.[26] *Dynamic efficiency*, also known as technical progress, measures innovation: namely, improvements in production methods and the quality levels of products.[27] Conflicts can arise between these elements in practice, requiring a trade-off between present and future welfare, which is a recurrent tension within economic regulatory policy.

Achieving efficiency in a market is not a given, however, as market theory incorporates numerous assumptions that condition its operation.[28] Becker suggested three such criteria: that individuals act rationally, maximising utility; that they have stable, ordered preferences, which inform their maximising behaviour; and that markets clear, meaning supply and demand reaches equilibrium.[29] Additional requirements may include sufficient information for actors to make rational choices, an absence of externalities that impede the market-clearing process, and a need for competitive markets.[30] Where one or more of these assumptions does not hold true – which, it should be emphasised, occurs with considerable frequency – the operation of a market may not achieve an efficient allocation of resources. This is 'market failure': namely, 'the failure of a more or less idealized system of price-market institutions to sustain "desirable" activities or to estop "undesirable" activities'.[31] Market failures may exist, *inter alia*, where buyers or sellers lack sufficient information to act efficiently,[32] for public goods,[33] for moral

[23] Viscusi et al. (2005:79); Motta (2004:18). [24] Vickers (1995:4).
[25] Viscusi et al. (2005:66); Motta (2004:18). [26] Gelhorn (1975:1); Motta (2004:40–52).
[27] Viscusi et al. (2005:67), Motta (2004:19). [28] Dempsey (1989:11).
[29] Becker (1976:5). [30] Ogus (1994:23–4, 30). [31] Bator (1958:351).
[32] Majone (1997:266).
[33] Public goods are non-rivalrous and non-excludable, meaning that any individual's consumption does not affect the consumption of others and nobody can be excluded from consuming the good: Bator (1958:369–71). For example, clean air and traffic lights

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hazards,[34] or when externalities such as pollution are not factored into transaction costs. Notably, for our purposes, monopoly *may* cause market failure if market power leads to a restriction of output or excessive prices, but it does not necessarily do so.[35] It has even been argued that distributional failures comprise a form of market failure inasmuch as existing market structures fail to secure an acceptable allocation of income.[36] While such an approach is difficult to square with economic conceptions of efficiency, concerns of justice and fairness have, as we shall see, frequently provided a legitimate rationale for market intervention. Given understandable concerns regarding the priority accorded in conventional discourse to market-focused problems in comparison with rights- or solidarity-based objections,[37] a more neutral formulation for this broader conception of dysfunctional markets is that of market 'defects'.[38]

Generally, economists schooled in neoclassical theory tell us that, where efficiency is the aim, the State should refrain from interference in the workings of the market, because the market itself secures a more efficient allocation of society's wealth than State-directed economic policy can achieve. Under market failure, however, the unencumbered free market produces a sub-optimal result, and so there is a *prima facie* case for State intervention to achieve a more desirable allocation.[39] The State has two principal mechanisms available to address market failures.[40] First, it can use price incentives – most obviously taxation – to encourage or discourage certain types of market behaviour.[41] Whilst important in practice – think, for example, of tax relief on pension contributions, or high taxes on cigarettes – such State action falls outside the scope of this work. Second, the State may attempt directly to control market behaviour through regulatory policy mechanisms, which prohibit or, conversely, require certain market conduct.

are public goods. Under a strict market-based approach, public goods are typically undervalued and underproduced.

[34] Moral hazard involves excessive risk-taking in circumstances where the risk-taker does not incur the costs of an unsuccessful gamble, a typical example being the decreased incentives of health insurance holders to minimise their medical bills because they do not pay the bill ultimately.

[35] Viscusi et al. (2005:2–3).

[36] Stewart (1988:111); see also New (1999:65).

[37] Prosser (2004:38).

[38] Breyer (1987:1006).

[39] Majone (1996:54), for example, identified the three main functions of government in the socio-economic sphere as income redistribution, macroeconomic stabilisation, and regulation comprising efforts to correct market failures.

[40] Viscusi et al. (2005:3).

[41] Jarass (1988:77–81).

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Competition law and sector-specific economic regulation both fall within the broad rubric of this latter category.

The economic models of market equilibrium and market failure, outlined earlier, provide a simplified (and not uncontroversial) explanation of the functioning – and shortcomings – of the market mechanism. This book is concerned, primarily, with circumstances where the market itself fails, in whole or part, thus prompting corrective intervention of a legal nature. In translating economic theory to legal rules and public-policy choices, however, several important qualifications must be added.

First, efficiency as an economic concept is unconcerned with questions of equity. The balance between consumers and producers within an income distribution is irrelevant to the question of whether a total distribution is efficient;[42] accordingly, 'the transformation of benefits from one form (consumers' surplus) to another (profit) is treated as a wash'.[43] Strictly speaking, the efficiency standard is compatible with very great inequality within society. Although efficiency is routinely used as a proxy for utility (societal happiness) in economics, the two concepts are not synonymous.[44] In particular, the notion of an economically optimal outcome fails to account for the critically important role that non-commodity values play in society.[45] Economists advocate a total welfare standard for economic analysis,[46] arguing, not without some basis, that the wealth of producers often returns to society through dividends, pension funds and taxation; consumers benefit from increased innovation; and wealth redistributive decisions belong, instead, within the political sphere.[47] Nonetheless, to the extent that markets are viewed, instrumentally, as a mechanism to serve society, efficiency as an end result is not always optimal. Consequently, although the market often provides the best outcome, in cases where non-economic values are better served by derogating from the market – so that total utility rather than total wealth is maximised – the latter outcome should be preferred.[48]

When economic theory is applied as a *legal* framework for market regulation, moreover, the adequacy of efficiency as a *normative* goal for a legal system becomes more pressing. The question is whether efficiency is

[42] Vicusi et al. (2005:66–7), Motta (2004:18); Bork (1978:90).
[43] Williamson (1977:711).
[44] See Posner (1979:111–35) for a strong critique of equivalent uses of efficiency and utility.
[45] Stewart (1983). [46] Motta (2004:18–21); Viscusi et al. (2005:9).
[47] Motta (2004:21). [48] See, e.g., Bator (1958:378–9); Prosser (2004:17–38).

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