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Regulation and the nature of competition

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ABSTRACT

Regulators are often required to assess the extent of competition in a market, and to promote competition or to substitute for it. Interpreting competition as a perfectly competitive equilibrium has led regulators to over-regulate. Interpreting competition as a rivalrous discovery process calls for lighter handed regulation. Around the world, regulators including some airport regulators have been encouraging approaches such as negotiated settlement between regulated companies and their customers. The CAA's use of constructive engagement by London airports is another example. However, in many cases, regulators with a duty to promote competition have discouraged it by undue price controls. The CAA's recent price control review is a case in point, although the CAA mitigated the situation by deregulating Stansted and allowing an airport-proposed price undertaking at Gatwick. This raises the question of when regulators are needed. In order to regulate an airport, the Civil Aviation Act 2012 requires the CAA to show that the airport has market power, *and* that competition law would be insufficient to address this power, *and* that the benefits of sector regulation outweigh the adverse effects. This proved effective and could be considered for other regulated sectors.

1. Introduction

I am honoured to be invited to give the Martin Kunz lecture. I did not know Martin, but others have spoken and written warmly of him (Starkie, 2005). His paper on airport regulation in Germany is often cited (Kunz, 1999). It reflects a mix of theory and practice, draws on evidence from many countries, and reaches a judicious assessment of the implications for policy. I take a rather different approach here, but nonetheless hope that he would have approved of it.

My own qualifications in aviation economics are limited.[1] I have therefore drawn also on my experience of regulation in other sectors such as telecoms, energy and water, mainly in the UK but also in North America. My aim is to consider the nature of regulation in relation to the nature of competition, with particular reference to airport regulation by the CAA. I also include some remarks about risk, since that is in the title of this year's European Aviation Conference.

Regulation applies to a wide spectrum of markets: those where there is monopoly, those where competition exists and those in transition to competition. For markets in the third category, regulators – in the UK at least - are often required to promote competition. This raises two obvious questions that regulators do not seem to have much asked themselves: What is competition? And how best to promote it?

I want to consider how regulation has actually been applied to these three different kinds of markets, and show how two different views of competition have different implications for regulatory policy. My feeling is that regulation hasn't always got it right, and has sometimes got it badly wrong. This leads me to conclude by asking when and where we need regulators, and to recommend for consideration in other sectors a useful test that has recently been introduced into UK airport regulation.

In his invitation to give the Kunz lecture, Hans-Martin Niemeier said "The emphasis is on changing aviation policy to improve economic welfare by sound economic theory." I would add that this is not a one-way street. Economists too have a lot to answer for. In my view, regulation has sometimes been led astray by unsound economic theory, while at the same time there are also examples of regulation, not least aviation regulation, that provide lessons for economics. We might therefore also put some emphasis on

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[1] I was an adviser to the CAA during its price control process 2005–9, and I have commented occasionally on airport regulation. Most recently I advised Gatwick Airport Ltd during the latest CAA price control review, and this lecture draws upon two of my papers that Gatwick submitted to the CAA (Littlechild, 2013a, 2013b).

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changing economic theory to improve economic welfare by sound economic regulation.

2. The spectrum of regulated markets

I had some involvement in the origins of modern UK regulation. In February 1983 I recommended the RPI-X price cap for British Telecommunications, which was intended to "hold the fort until competition arrives"(Littlechild, 1983; para 4.11). It was designed for a sector that was expected to become competitive in due course. In November 1983 Michael Beesley and I wrote a paper for the Treasury on how to bring competition to monopoly sectors, with the emphasis on restructuring and removing entry barriers (Littlechild and Beesley, 1983). I focused on the electricity sector while Michael focused on airports. (Martin Kunz later considered similar issues (Kunz, 1999)[2]) Then in 1986 I was asked how to regulate the water sector, which was expected to be a continuing monopoly (Littlechild, 1986).

Subsequently, the UK government adopted the RPI-X form of incentive regulation for all privatised utilities, including airports. In this sector, too, there was and still is a spectrum of markets:

- Monopoly and/or market power that in 1986 was deemed to exist at Heathrow, Gatwick, Stansted and Manchester airports
- A transition to competition that is now deemed to have taken place at Manchester and recently at Stansted but to be still in process at Gatwick and not in prospect at Heathrow
- Competitive markets at about 50 other UK airports, not hitherto price regulated (some of which do not have regular scheduled services).

How then to design an appropriate regulatory policy for each airport?

Where there is monopoly, regulation is often seen as a substitute for competition. But where there is a prospect of competition, most UK regulators, although the CAA only recently, have a duty to promote competition – or more recently, to promote the interests of customers/passengers, where appropriate by promoting competition. This raises various questions:

- Whether to "mimic" or substitute for competition in a monopoly market, and if so how?
- How to promote competition in transitional markets, and how to decide when it is appropriate to do so?
- How to tell when a market is competitive?

Thus, a view of the nature of competition should - and for better or worse generally does - inform regulatory thinking, but it is seldom made explicit. What, then, is competition?

3. The nature of competition

The most familiar interpretation is that of perfect competition. This has been the standard benchmark in economic textbooks for at least the last half century. In its simplest form it assumes a single product, with many buyers and sellers, and full information. The model is timeless. The market is characterised by a static equilibrium price where supply equals demand. Price is equal to cost, and there is zero excess profit (above a normal return to capital).

In this approach, perfect competition stands in contrast to monopoly, that is, a single seller. Here too the market is characterised by full information and a static equilibrium price where supply equals demand. But price exceeds cost, and the monopolist makes a positive profit (above a normal return). Between perfect competition and monopoly lie various degrees of market power, all analysed in a static context.

This perfect competition model has driven much (but not all) regulation (including airport regulation) over the last 30 years. For example, the ability of a company to set price above cost is seen as an indicator of market power, hence of the need for regulation. The typical regulatory aim is to set price equal to cost, as it would be in a perfectly competitive market. Departures from perfect competition are also seen as a basis for other forms of regulation (e.g. to prevent price discrimination, "unfair pricing" or complex tariffs).

There is, however, an alternative view of competition. This sees competition as a rivalrous discovery process taking place over time. "Competition is by its very nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying static analysis" (Hayek, 1946).

This alternative view of competition as a process is associated with Adam Smith and with the work of the Austrian school economists Schumpeter, Hayek and Kirzner (Schumpeter, 1950; Hayek, 1948a, 1948b, 1978; Kirzner, 1973, 1985, 1997a, 1997b). It is not found in most economics textbooks. But it is a view that is reflected in the Competition Authority Guidelines: "Competition is a process of rivalry as firms seek to win customers' business. It creates incentives for firms to meet the existing and future needs of customers as effectively and efficiently as possible — by cutting prices, increasing output, improving quality or variety, or introducing new and better products, often through innovation; supplying the products customers want rewards firms with a greater share of sales." (UK Competition Commission, 2013; para 10).

This same view has also been emphasised over the years by successive chairmen of the UK Competition Authorities. Thus, for example

- "competition is, to an important extent, a mechanism by which new ideas emerge and the best ones survive, only to be superseded by other still better ones." (Morris, 2003)
- "The process of competition is the means by which good ideas succeed while bad ones fail, well-run firms thrive while bad ones reform or perish, and a constant pressure for innovation is maintained. … This [Adam Smith] concept of 'rivalship' (now modernized to 'rivalry') is critical to the operation of the Market Investigation regime." (Freeman, 2007)
- "the Austrian School's view of markets and competition as a process of rivalrous discovery, with continual change and evolution, rather than embodying the concepts of optimality and equilibrium, is more helpful" (Currie, 2014).

How then does the competitive process view differ from that of perfect competition? It is

- dynamic rather than static
- about disequilibrium, not equilibrium
- about prices above or below cost, not generally equal to cost
- about firms making changes to prices, quality, and products, not about taking these aspects as given
- about firms discovering and providing what customers want, better than rival suppliers, rather than knowing already what customers want
- about searching for profits and avoiding losses, rather than existing at zero profits
- about entrepreneurship and innovation rather than a world in which there is no role for these activities

[2] He particularly references (Starkie and Thompson, 1985). This paper is summarised in "Privatisation and Structure", Ch 4 in Starkie (2008).

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