



CPI Antitrust Chronicle

July 2011 (1)

The Challenge of Competitive Neutrality in Public Procurement and Competition Policy: The U.K. Health Sector as Case Study

Simon Taylor
Wragge & Co. LLP

The Challenge of Competitive Neutrality in Public Procurement and Competition Policy: The U.K. Health Sector as Case Study

Simon Taylor¹

I. INTRODUCTION

Competitive neutrality describes the aim of a level playing field in mixed public/private markets, where state-owned or quasi-public bodies line up to compete with private sector companies. These markets tend to be distorted as a result of structural advantages enjoyed by public providers and a failure by public buyers to ensure fair process. A range of policy tools can be employed to achieve competitive neutrality.

The OECD paper, *Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options*,² of May 2011 looks at this problem. It advocates full implementation of the 2005 OECD Guidelines on Corporate Governance of State-owned Enterprises. This recommends measures designed to mitigate the conflict of interest in the state being both regulator and provider.

In the United Kingdom, the Office of Fair Trading (“OFT”) published a working paper in July 2010, *Competition in Mixed Markets: Ensuring Competitive Neutrality*, which suggests a more uniform approach by government bodies, fairer procurement, and the full application of competition law to state-owned enterprises.³

The European Commission published a *Discussion on corporate governance and the principles of competitive neutrality for state owned enterprises* in September 2009.⁴ The Commission’s paper focuses on the European Union (“EU”) state aid rules and the exemption under Article 86(2) (now 106(2)) of the Treaty on the Functioning of the European Union (“TFEU”) to the application of competition and state aid rules to undertakings entrusted with the operation of services of general economic interest. It concludes that state aid rules enshrine competitive neutrality and give the European Commission the tools to ensure that this is achieved.

However, perhaps the most developed paper on the subject was the CBI paper from January 2006, *A Fair Field and No Favours*,⁵ *Competitive Neutrality in UK Public Service Markets*.

This article takes stock of the challenges presented by mixed markets and the competitive neutrality challenge with particular reference to the U.K. National Health Service (“NHS”) and the Health and Social Care Bill (“Health Bill”). The Health Bill proposes to give Monitor, the

¹ Antitrust Partner at Wragge & Co. LLP.

² OECD Corporate Governance Working Papers No 1, Capobianco and Christiansen.

³ OFT 1242. The OFT also suggests that U.K. bodies such as the Shareholder Executive, which manages Government shareholding in U.K. businesses, should ensure that publicly owned bodies are run at arm’s length from their owners to avoid market distortions.

⁴ DAF/COMP/WP3/WD(2009), Capobianco - Working Party No 3 on Co-operation and Enforcement.

⁵ Gary Sturgess, Serco Institute.

regulator of NHS foundation trusts, certain economic regulatory powers and concurrent powers to enforce the Competition Act 1998 in relation to the U.K. health sector.

II. WHY COMPETITIVE NEUTRALITY?

It is generally accepted that a level playing field is essential to realize the benefits of competition. Obstacles to competitive neutrality in mixed markets include grants of preferential pension or tax treatment to state-owned or quasi-public providers, public procurement practices which favor public providers, the inconsistent application of competition law, and grants of subsidies or guarantees against failure to public providers.

In many instances, these practices and measures will infringe either public procurement or competition law, notably state aid law (Articles 107 to 108, TFEU⁶) or the Article 106 obligation on Member States not to adopt measures relating to public and monopoly undertakings which are contrary to the competition and other Treaty rules. In other cases, preferential treatment will be justifiable⁷ by reference to public service responsibilities, such as an obligation to provide a 24-hour accident & emergency service or a universal post service. However, the requisite elements of EU competition law (such as cross border effects) will not always be present⁸ and many “lawful” practices or measures could hinder competitive neutrality.

Competitive neutrality is also relevant to addressing incumbency advantage, particularly in relation to large public tenders. While not all incumbents will be public- or quasi-public bodies, they will often be former monopolists or public companies and may be dominant in their market. There is a tendency in public procurement to accept that the incumbent will always have an advantage in terms of costs, access to information, and experience. Competitive neutrality can include taking active steps to neutralize the incumbent’s advantage with a view to enabling a more effective competition. Some examples of barriers to competitive neutrality are set out below.

III. STRUCTURAL ISSUES

The OFT’s working paper notes that in markets such as NHS healthcare, where private providers compete against NHS trusts, private providers suffer a cost handicap of 2-4 percent as a result of corporation tax.⁹ Public and “third sector” operators (for example, charities) are exempt from paying tax.

The OFT also refers to VAT treatment as a useful case study. The U.K. Royal Mail’s VAT exemption was challenged by a competitor, TNT Post NV, on the basis of EU legislation liberalizing and regulating the postal services market. The European Court of Justice (“ECJ”)¹⁰ concluded that, while the VAT exemption may be justified in non-liberalized markets where Royal Mail performs its universal service obligation, the VAT exemption should not apply in

⁶ Treaty on the Functioning of the European Union. Article 107(1) states that “... aid granted by a Member State ... which distorts or threatens to distort competition by favouring certain undertakings .. shall in so far as it affects trade between Member States be incompatible with the common market.”

⁷ Article 106(2) limits the application of the Treaty rules to undertakings entrusted with a service of general economic interest where this would obstruct the public tasks.

⁸ U.K. competition law does not contain any equivalent provisions to Articles 106 to 108.

⁹ Research by the Office of Health Economics: *How Fair? Competition between independent and NHS providers to supply non-emergency hospital care to NHS patients in England*.

¹⁰ R (TNT Post UK Ltd) v HMRC, Case C-357/07.

competitive markets. The ECJ invoked the principle of “fiscal neutrality” in reaching this conclusion.

Similarly, where employees of public providers have access to a state pension scheme, as NHS employees do, these providers may have a balance sheet advantage in bidding against private providers that have to meet pension costs.

The European Commission points out in its paper that structural disadvantages also apply to public sector providers and measures to redress these will not necessarily infringe state aid rules. By way of example, funding provided to a public bus operator in order to transition “officials” to the less remunerative status of “employees” was permissible to remove a cost disadvantage against private sector competitors.¹¹ Clearly, no two cases will be identical and the net effect of structural differences will need to be assessed.

In relation to access to funding, the OFT points out that public sector operators are able to borrow capital at lower rates than their private sector counterparts. This reflects the perception that the public sector provider will be bailed out by the Government and therefore represents a lower credit risk. In the United Kingdom, the Government has subsidized NHS hospital trusts with deficits in order to keep them in operation. This question of what a failure regime should look like in the NHS is a key issue under the Health Bill. In other liberalized sectors, such as rail and water, a special administration regime allows for the failure of providers while ensuring that the ongoing provision of essential public services is protected.

The impact assessment for the Health Bill noted that “the majority of the quantifiable distortions work in favour of NHS organisations: tax, capital and pensions distortions result in a private sector acute provider facing costs about £14 higher for every £100 of costs relative to an NHS acute provider.”

This statement provoked much debate in the House of Commons Public Bill Committee.¹² David Bennett, the Chief Executive of Monitor, pointed out that this was a preliminary analysis that may not take into account some of the costs burdens that need to be borne by NHS providers, including training and R&D. He also pointed out that NHS foundation trusts are restricted in a number of the commercial activities that they can undertake (for example, individually set caps on private patient income) and, in fact, are limited in the extent to which they can seek capital from the market. One of the key challenges of NHS reform will be to ensure that the balance of structural rights and obligations of foundation trusts is fair when compared to those of the private new entrants, having regard also to the need to safeguard the performance of essential public services. This challenge is further explored below.

IV. PUBLIC PROCUREMENT

It is a common feature of competition in mixed public/private markets that competition takes place “for the market” rather than “in the market.” This involves a series of advertised public tenders, which are also generally subject, in the EU, to public procurement law. EU public procurement law requires that tenders be run in a transparent and non-discriminatory manner.

¹¹ Case T-157/01 *Danske Busvognmoend v Commission of the European Communities* [2004] ECR 11-00917 (Combus).

¹² Transcript of February 10, 2011.

This therefore presents a further opportunity for Government, at the EU or national levels, to achieve competitive neutrality.

In practice, public procurement does not always take place on a level playing field. For example, there are many instances where in-house bid teams, or joint ventures between the procuring authority and a private sector partner competing for the contract, are given preferential treatment. These can include the managers of an in-house bid team being involved in running the tender process or the public/private joint venture being awarded the contract without a tender.

Another example is the use of an undisclosed public sector comparator. In many cases, the cost of continuing the services in-house is used to benchmark the cost of private sector bids, with a view to deciding ultimately whether or not to grant the contract to the winning bidder. There is a general rule of public procurement that, until the contract is awarded, authorities can change their mind and decide not to award the contract¹³. But public procurement law also requires transparency of award criteria.

Arguably this includes any public sector comparator.¹⁴ The failure to disclose this in advance is unfair on the winning bidder who is denied the contract. This practice also reduces the willingness of bidders to invest in tenders, with a chilling effect on competition for the market.

Incumbency advantage is a common barrier to competitive neutrality. For example, the incumbent may refuse to make available key data or otherwise exploits its position to secure a favored foothold in the competition. Authorities may seek to ensure that the incumbent makes available all information relevant to bids in the data room. However, in practice, unless there is provision in the contract for the incumbent to do this, there can be disputes over the ownership of the data and intellectual property issues. This issue has arisen, in particular, in relation to rail franchise tenders.

Competition law may also be relevant here. If the incumbent has IP ownership in data that competitors would need to access for a fair competition for the market to take place, there may be good arguments that the incumbent enjoys a dominant position and should be required to license the data to bidders. If the incumbent's foothold results from the contract (for example, a right of first refusal over competing bids) then this may well infringe competition law and is also likely to place the authority in breach of the procurement rules.

Another advantage commonly enjoyed by incumbents is that the successful new entrant may need to incur substantial transition costs in order to mobilize. This is a problem in the IT sector, where new systems may need to be introduced. An example given by the OFT in its paper was in the United Kingdom; specifically, Her Majesty's Revenue & Customs ("HMRC") 2004 procurement of the £3bn IT outsourcing contract, Aspire. HMRC contributed to bidding costs by paying the winner's costs in taking over from the existing supplier and discounting the transition costs for the purpose of comparing bids. The contract was worth about £3.8bn and the

¹³ The TFEU does not prejudice the rules in Member States governing the system of property ownership and, in most cases, this will mean that there will be no EU obligation on public authorities to privatize or liberalize in-house services. Though in certain sectors, such as energy, telecoms, and ground handling the Commission has invoked its powers to require liberalization.

¹⁴ See *Montpelier Estates v Leeds City Council* [2010] EWHC 1543 (QB) for judicial comment on this argument.

£75m spent on the costs of procurement and transition was considered to be a valuable investment in order to maximize the benefits of the competitive process. The National Audit Office carried out a value for money report¹⁵ on the procurement and concluded that there was good justification for using incentives of this kind to encourage competition.

There may be concerns that adjusting bids in this way in order to ensure that a like-for-like comparison is conducted might infringe the EU principle of non-discrimination in tendering. However, the better view is that this is consistent with the non-discrimination principle given that its effect is to redress an imbalance rather than to create one.

A similar issue has arisen in the debate over the advantages enjoyed by NHS trusts over private providers in the health sector. The Heath Bill's impact assessment conclusion that NHS providers enjoyed a 14 percent cost advantage raised the concern that commissioners would be instructed to discount the bids of private providers by 14 percent in order to neutralize this advantage, with the consequence that a cheaper bid from an NHS provider might lose out to a private bid. As indicated above, Monitor's response was that a more comprehensive analysis of any cost advantage enjoyed by NHS providers would be needed. However, commentators¹⁶ have expressed the view that once the net benefit enjoyed by NHS trusts is quantified, it may be appropriate to ensure that where NHS providers engage in competitive activities, the relevant percentage (comprised by the net cost advantage) of any revenue gained would be paid into a fund to pay for the pension, tax, and other benefits enjoyed. This would remove the cost advantage currently enjoyed by NHS providers. Indeed, this adjustment may be required by state aid law, as explained below.

V. COMPETITION AND STATE AID LAW

The European Commission's paper sees competitive neutrality as being a matter that can be largely dealt with through state aid tools and levers. It is true that there is developed case law¹⁷ and a specific Commission exemption decision¹⁸ that deal with the question of how to compensate public and private undertakings for services of general economic interest. The point here is that if public providers are able to use the financial benefits that they enjoy in their public service capacity, such as access to a public sector pension, to subsidize commercial activities where they are in competition with private bodies who do not enjoy such benefits, then this involves the transfer of state resources (the pension contributions) to an undertaking (the public provider) in a manner which distorts competition on the market.

In the NHS, if foundation trusts do enjoy a net cost benefit (as a result of NHS pension, tax and other structural entitlements) in competing for NHS contracts against private providers, they may be enjoying state aid. This may be unlawful save insofar as it can be brought within the Commission's 2005 exemption decision. The conditions of that decision include, among other things, the obligation to maintain separate accounts between services of general economic interest and commercial activities and ensure that payment for these services does not exceed necessary cost plus a reasonable profit. In effect, EU state aid law and the conditions of the 2005

¹⁵ HC 938 Session 2005-2006, 19 July 2006.

¹⁶ See, *Tariff could be designed to boost private firms*, HEALTH SERVICE J., (January 27, 2011).

¹⁷ Altmark, Case C-280/00 2003.

¹⁸ Commission decision of November 28, 2005 on the application of Article 86(2) of the EC treaty to state aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest (OJ L 312, 29.11.2005).

exemption decision may require that a competitively neutral solution is found to the problem which is being actively debated in the context of NHS reform.

The difficulty in neutralizing structural benefits and thus ensuring a level playing field is that the equation is often complex. In the healthcare sector, even once the net benefit enjoyed by the NHS provider has been calculated, it may not be as simple as discounting the private bid to an equivalent amount and ensuring transparent accounting. This is because there may be other unintended cost consequences of granting the contract to the private sector provider. For example, if part of the revenue gained by the incumbent NHS foundation trust in the provision of elective services is actually being used to cross subsidize certain public service activities which have not been put out to tender, such as accident and emergency services, the loss of the contract to the private sector bid may undermine the viability of the other service of general economic interest.

This is one of the reasons why the issue is so political. The fear is that competition for less complex services will destabilize the provision of essential healthcare. Clearly, a thoroughly considered holistic view will need to be taken in relation to emerging markets such as healthcare so as to ensure that proactively removing barriers to competitive neutrality has no unintended impact on essential public services. The conditions set out in the 2005 exemption decision (as well as case law on the Article 106(2) TFEU exception) may be a useful starting point for this exercise, but are unlikely to be more than that.

The other concern in relation to competition law enforcement is that competition powers are not typically used against public sector providers. There is developed case law on the definition of an undertaking within the meaning of the Competition Act 1998 and the TFEU Articles 101 and 102.¹⁹ However, it is rare for the OFT to take action against a public body which is operating on the difficult-to-define borderline between its public service remit and market activity.²⁰ The Ofcom investigation of agreements entered into by NHS trusts with bedside communication systems providers in 2006²¹ was a rare example of Competition Act powers being used to investigate public providers. It may be expected that, as the NHS is further opened up to competition and choice, competition law will increasingly be held to apply to bodies such as foundation trusts and even individual clinicians. This part explains the move towards granting powers to enforce the Competition Act 1998 to a sector specific regulator, Monitor.

In the first draft of the Health Bill, Monitor was also to be given the duty to promote competition where appropriate to further the interests of patients. This was controversial and has been removed in the latest amendments. Competitive neutrality principles do not impose any obligation on Government to open up sectors to competition. In effect, the competitive neutrality challenge only arises once the liberalization decision has been made and the market created. In itself, competitive neutrality should not court political controversy though inevitably it is linked to more political issues such as the pace of liberalization and the delivery of essential public services.

¹⁹ Fenin v Commission, Case T-319/99.

²⁰ See OFT, The Competition Act 1998 and Public Bodies, Policy Note 1/2004 August 2004.

²¹ Ofcom's own initiative investigation into the price of making telephone calls to hospital patients. Case closure document, January 18, 2006.

VI. CONCLUSION

In the EU, most of the bumps in the playing field on which public and private operators compete can be leveled out by the full application of procurement and competition law, including state aid law. But many of the issues are structural and require a contentious assessment of the benefits enjoyed by public providers as against the public services role they fulfil and an attempt to neutralize any net advantage. In the U.K. healthcare sector, this is complex and political, but important given the potential benefits of fair competition.