

Easyjet: the future of the company under government intervention assignment



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Introduction Since the inception of the aviation industry, it has had an amazing expansion with passenger growth still at 14% as recent as 2010 [The Economist, 2011]. For the years the aviation industry has been running, each flight causes a negative externality ??? a root cause of market failure. To solve this problem of market failure, governments have intervened by introducing a number of regulations over the year, to protect the welfare of society.

However, the externality the aviation industry causes cannot be solved so simply. Pollution of CO₂ and NO_x gasses are the negative externalities caused by each flight, and with daily flights the damage is forever raising. To overcome this market failure in the aviation industry, the European Union Trading Scheme will be introduced from 2012. The government will intervene by placing a cap on the amount of gasses firms are allowed to release through their flights. The theory of the plan suggests that emissions will reduce over time and will push airlines to find alternative resources.

What's The Problem? Market failure is the term that economists use to describe situations where one person incurs costs or enjoys the benefits of another's action [Shiell, A, 2010]. There are four main reasons as to why market failure occurs: Monopoly power, Public goods (see Appendix A), Asymmetric information (see Appendix B) and Externalities. Within the airline industry, the latter comes into play. Market failure caused by externalities occurs when a party that is not involved in the decision making (third party) is affected as a result of that decision.

There is a negative spill over effect and this causes markets to become inefficient and therefore fail. Externalities are effects of production or consumption on third parties where the price does not cover the full social cost. They are classed as positive (see Appendix C) or negative (see Appendix D) [Helbling, T, 2010]. It is deemed that the externalities of the airline industry have more adverse effects in the form of pollution, which may lead to a decreased quality of life. This problem has been further emphasized in the wake of the constant concerns of global warming in the media.

There is also the issue of other externalities such as noise pollution (see Appendix E), congestion (see Appendix E), and the forgone production in terms of a polluted area (where an airport is located) is likely to affect activities such as tourism. Negative externality caused by market failure occurs due to the market not taking into consideration the complete social cost of an action. As firms are profit maximising entities as described by neo classical economics, they will produce a greater quantity of products compared to what is socially desirable.

Taking an example of the aviation industry, the social costs of the airliner carrying out more flights is an increase in pollution and the release of other toxic gasses. Equilibrium Quantity 0 Price QMARKET Demand (private value) Supply (private cost) Social cost QOPTIMUM Optimum Cost of pollution As seen by the diagram, the social optimal output level is where the demand curve intersects with the social cost curve. But this is not the case as the current equilibrium is below the optimum one, as private firms only take into account private costs, creating inefficiency and hence market failure. Graph <https://assignbuster.com/easyjet-the-future-of-the-company-under-government-intervention-assignment/>

Adopted from: Harcourt Brace & Company. 2011). Externalities, Chapter 10. p16. There are a number of policies that can be put into the place in order to combat market failure. They may be private such as negotiation and compensation, or they may be implemented by government. Through direct or indirect measures such as command and control policies or market based policies such as Pigouvian taxes. (Appendix F). The government had meticulously assessed the aviation market and concluded that there was a noteworthy negative externality in the industry. This externality caused by air travel became the government's main concern of the industry.

They discussed this at the Kyoto Protocol (see Appendix G) and decided to use command and control policies to regulate the industry in order to tackle the problem. There were three mechanisms that came about from the protocol and the third mechanism was deemed most important to the aviation industry; the European Union Trading Scheme (EU ETS). This scheme aimed to be the primary method to reduce emissions. The idea of the EU ETS revolves around the introduction of the carbon market and the cap-and-trade system. This system was introduced in 2005 and commenced an initial trial period to create the markets infrastructure.

During the trial period 12, 000 facilities within the EU had been placed with an emissions cap, they were not allowed to pollute more than the cap stated but they were allowed to trade these permits if in surplus. The tradable characteristic of these caps gave firms the opportunity to create abnormal profit by selling them onto other firms that need the extra emission permit.

[A. Denny Ellerman and Paul L. Joskow, 2008] The topic of much debate has been as to whether governments should have intervened in the industry. It is <https://assignbuster.com/easyjet-the-future-of-the-company-under-government-intervention-assignment/>

proven that the air industry only produces 2% of the total greenhouse gasses in the E. U.

Therefore, it is hard to pinpoint why governments have targeted the industry in the EU ETS. The EU have stated the main reason for this was to reduce emissions, but, there is evidence in other industries that shows an increase in taxes will not have an effect on pollution. It is important for easyJet to read Appendix H, as it will show that governments might change their approach if their current choice proves ineffective. This will help easyJet know what might be expected of the industry in the future and may also give the firm a case to argue of the current pollution cap which may be deemed unfair by private companies.

The Outlook for easyJet The main carriers in the UK are easyJet, Ryan air, flybe and bmibaby. They offer lower prices due to a number of characteristics such as direct booking, high seating density, uniform aircraft types (less economies of scale on servicing and maintenance), the use of secondary or cheaper airports and no frills such as free food and air miles (see Appendix I for further information). The main selling point of easyJet is its low prices. With the new regulations being implemented by 2012 (see Appendix J), expenditure will be sure to go up but this will not only affect the individual company, but the air industry a whole.

These systems set up by the Kyoto protocol will cause drastic changes to the budget airline industry. The various firms will have to rethink their cost structure and their business plans. easyJet will need to assess what changes it will have to make and how this would affect them against their

competitors. In order to assess the market place, and how easyjet will be affected, Porter's five forces model needs to be examined. It consists of substitutes available in an economy, the threat of new entrants, the power of the customer, the power of the supplier and the threat from direct competitors. Porter, 2008) The first main threat arising due to higher costs is that of substitute products. The firm will need to analyse its costs compared to alternative means of transport like trains. Currently, short haul distances are cheaper via train but for a long haul journey it is cheaper to use budget airlines, as seen by the diagram to the left. But, this is about to change with new regulations to reduce CO2 emissions, increasing expenditure for budget airlines. Also, trains are becoming cheaper as they are electric and switching to a full online booking service.

The main limitation with people switching to trains is the time constraint. Although the gap in price for long haul flights will reduce, it is hard to see customers moving to trains for these longer distances and the fact that most trains are not direct further makes it eluding for customers to keep use trains. This raises the question, if prices increase, won't people move to more luxurious airliners such as British Airways and Virgin? This is not the case as the non budget airlines in the industry are all currently performing inefficiently when compared to the budget airlines, and it is this characteristic that will be their downfall.

With costs rising due to increasing oil prices (see Appendix K) and the expenses of implementing new technology, budget airlines will still prosper. They are available to provide such a low price and their competitors like B. A will be forced to drop their price and make up the profits elsewhere, if <https://assignbuster.com/easyjet-the-future-of-the-company-under-government-intervention-assignment/>

possible. Non budget airlines are beginning to correct their inefficiency and are diversifying to stay alive in the industry but with the finite amount of oil, the budget airlines currently have an upper hand. Dr Patrick Dixon, 2008]

The suppliers, in this case, the manufactures of the planes play an essential role, now more than ever, as it is up to them to figure out ways to make planes more efficient. The various firms have taken different approaches on how to deal with government intervention and environmental issues. Airbus advertised their aircraft, the A380, as being ‘ more fuel efficient per passenger kilometre than a small family car’ [Emirates, 2011]. A list of further features of how the A380 and Emirates are driving towards fewer emissions is available in Appendix L. asyJet have also developed their technology to combat the problem by creating an unducted fan-driven aircraft that its officials believe is the next best thing in fuel efficiency [Commercial Aviation Report, 2007]. To be able to reduce CO2 emissions in the aviation industry there has to be a full focus on ways to reduce them, such as investment in new technology so planes can use alternative fuels (Appendix M) or become more efficient. This creates a trade-off where other problems caused by the aviation industry, noise pollution and the amount of NOx in the environment, will have less focus on them due to the efforts on the CO2 emissions.

The suppliers of aircrafts, such as Boeing and Airbus, need to account for this. With the new regulations in place, the main threat is still easyJet’s direct competitors. The current growth in the airline industry is stagnant and will reduce in the coming years as evidenced by Appendix N and this means the firm will need to think of new, more shrewd strategies in order to survive in

the market place and a list of recommendations have been listed below. The fight between competitors will now be fiercer than ever, especially between the big two of the low cost airline industry; Ryan air and easyJet.

The budget airlines structure is much the same between these firms and it is important for easyJet to use a competitive strategy. Although with these new regulations, new firms will be reluctant to venture into the industry but if incumbent firms are inefficient, new airliners will come into the industry.

Recommendations As the new regulations come into place, drastic changes will be made in the air industry. With pledges to reduce carbon emissions and switch to bio fuels, easyJet will have to adjust and remodel its framework.

The question on how to reduce emissions is at the top of any firm's agenda and what method it will use to tackle this problem will be crucial. The general aim is to reduce emissions via newer planes which are seen as greener and thus have a lower carbon footprint. easyJet's biggest competitor, Ryan air, struck deals with certain airports to reduce costs for them in order for the plane carrier to bring economic benefits to the area. But this plan has backfired as the various airports are finding the deal not viable and these deals are currently being looked in to by the European Commission.

When easyJet looks at a way to keep costs low, they should not follow this system as it is deemed illegal and unethical by many but instead should investigate alternative methods. In order for easyJet to set its self apart, it will need to concentrate on competitive strategies such as cost focus or differentiation focus. [Porter, 1980] With cost focus, a firm aims to achieve

the lowest costs in the industry. Does the firm then invest in latest technology? This action will be capital intensive in the short run but will help in the long run.

Do they concentrate on the short run and keep shareholders happy by simply purchasing excess pollution permits? With budget airlines, the factor above all others is the price. Passengers are not concerned with the pollution emitted; as long as prices remain low. Consumers are happy to pay the minimal price, and if they weren't, they would be travelling on a more luxurious plane such as BA or Emirates. easyJet's current stance is to constantly upgrade to new technology as they believe this will increase efficiencies but it is advisable for them to just buy new permits to keep costs low, and to invest in new planes only when need arises.

Advertising plays a huge role in the modern world. We see adverts everywhere and corporations pay millions to place their name and logo on various places. What if the airliner sold advertising space in the actual planes? Costs could be considerably reduced if there were advertising opportunities on the flight whether it is on the reading material or on the screens in front of the passenger. The idea of placing adverts to ease costs comes from Freeconomics developed by Chris Anderson. These savings could be passed onto the passenger through lower ticket prices, or simply kept by the company and used for purposes such as growth.

Differentiation focus is where a firm sets itself apart from the competition by doing something different. There is currently a gap in the market for mid airlines, in terms of those that are between the range of the premium and

budget airlines. The firm can exploit this and step up its efforts to excel in the market. With this the firm can charge a higher price which will offset the higher costs but in return give the consumers services that add value to the product such as car rentals, free food, and higher luggage weight capacity.

Also increased customer service will be beneficial if they decide to bump the prices up. There is a lot of talk for the use of alternative fuels such as bio fuels and hydrogen, but the advisors point out that it is still not yet a viable option for the firm. As airlines do not manufacture their own planes, they are reliant on the manufacturers like Airbus and Boeing to incorporate planes with these new technologies and at the same time making it commercially viable. These planes will then be available throughout the industry pushing the market more towards a perfect one with homogenous products.

But this again ties in with the long-term short-term plan and if the firm are reluctant to invest, they will keep using existing aviation fuels. If other airlines change, then the price of aviation fuel will reduce as the demand will be lower. From the advisors point of view, it will be more profitable to stay in the current segment due to factors such as the global economy being stagnated. In order to remain competitive and increase market share, costs need to be kept to a minimum and this will be achieved by the combination of buying excess permits and advertising.

These new regulations will not only be faced by the firm in question but will be faced through the industry as a whole. The way in which the individual airlines react will show whether or not it will survive in this tightening industry. Appendix Appendix A Monopolies – It is easy to see why there is

market failure when there are monopolies in the industry and it is because as they have a negatively sloping demand curve, they will tend to maximise profits by ensuring outputs remain at a level where marginal costs are exceeded by price.

Public Goods – With public goods, market failure arises as the firm usually has no-rivals and it is not excludable meaning any losses are reimbursed from public tax money. Appendix B Market failure due to asymmetric information occurs when one party of a transaction has more information than the other group. One market where this occurs is in the used car market where there is the lemons problem. Adverse selection happens before the transaction as only high-risk consumers will want to buy insurance. Moral hazard occurs after the transaction as once you have insurance, you are likely to act in a more risky way.

An example of this is that airliners are likely to operate in risky conditions such as those of the Icelandic ash cloud as they know if the plane gets damaged, the insurance company pays. Quantity 0 Price QOPTIMUM Demand (private value) Supply (private cost) Social cost QMARKET Value of spillover Equilibrium Optimum Appendix C Positive externalities occur when those individuals who are not directly in the market for the good in question gain benefits. Positive externalities may also have an adverse affect on markets and thus could lead to market failure as a smaller quantity than that which is socially desirable is produced.

As seen in the diagram, the intersection of the demand curve and the social value curve determines the optimal output level. The efficient output is

below the market equilibrium quantity. The aviation industry may bring about positive externalities such as employment opportunities and R&D; this has positive effects pasts the producer as the knowledge gained in this process may lead to other discoveries and developments. Appendix D

Negative externalities transpire when there is a cost to an individual who is not directly involved in the production or consumption of a particular good e. . cigarettes. Equilibrium Quantity 0 Price Q_{MARKET} Demand (private value) Supply (private cost) Social cost Cost of pollution

If there are negative externalities, the cost of production to society is larger than that to the producer. The supply curve will have to be shifted upwards in order to accommodate for the full cost of production to the society. Appendix E Noise pollution has been a growing concern ever since the aviation industry was set to grow at an exponential rate. It is the local residents that are in the vicinity of the airport who are mainly affected by this.

There has been research to suggest that the noise caused by aircrafts is damaging to humans, there is a full list published by the World Health Organisation stating the effects of noise in Appendix G. As well as being a general annoyance noise damages health, it detracts significantly from the quality of life, it stops local residents enjoying their gardens or simply enjoying peace and quiet, it damages wildlife, it damages the learning ability of schoolchildren and it costs a great deal of money through the costs of noise mitigation and noise abatement. [John Whitelegg, 2000]. The World Health Organisation(2010) states that noise has a number of adverse effects which include, hearing impairment, cardiovascular effects and pschedocrine effects. To add more to local resident woes, airports generate an amazing

amount of congestion on the roads. It is a hotspot for taxi's, buses and trains. All of these add to the general emissions we as a human race pollute. Appendix F To combat externalities there may be a number of private solutions available, one in particular is in the form of negotiation and compensation.

This would mean the people producing the negative externality reimburse the third parties, other producing positive externalities are compensated by the third parties. Others may be social sanctions and moral codes. Private solutions do not always work and in the case of this occurrence, public solutions need to be taken into account to solve the problem in the form of direct or indirect government's participation in markets. Figure Adopted from: Office of Fair Trading. (2009). Government In Markets: why competition matters. 14. The two main reasons as to why governments directly intervene in markets are to provide public goods and services that free markets would be unlikely to provide at an appropriate level and to benefit from the commercial value of public sector assets (Office of Fair Trading, 2009).

Command and control policies are the regulations set by government and include forbidding certain behaviours like disallowing smoking on the plane, and it could also make certain behaviour necessary such as investing in low emission technology.

This method of intervention is usually used in the aviation industry.

Governments intervene indirectly where there are private markets that produce side-effects that have an impact on social welfare. They include certain acts like the use of tax or subsidies to combat market failure. Price

Effects of a Tax Quantity Private cost with tax Private cost Private value
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Social Value $P_2 P_3 Q_2 Q_1 Q_3 Q_1 = \text{Market Value } Q_2 \ \& \ P_2 = \text{Full Social Cost}$ In the aviation industry, certain market based policies are in the pipeline and may come to affect in the form of Pigouvian taxes such as fuel tax.

As can be seen, the fuel tax could increase the price of an airline trip to P_3 which might make consumers feel a lesser need to travel and demand would move to Q_3 . With this tax on fuel and the current increase in fuel prices due to the unrest in the Middle East, people would find it cheaper to use others means of transport such as trains and ferries and could this be the demise of budget airlines. Appendix G The Kyoto Protocol was a meeting within the United Nations Framework Convention on Climate Change in Kyoto, Japan in 1997. It was in this meeting that 37 industrialized countries agreed to band together to reduce global emissions.

From this meeting three mechanisms came about on how to reduce emissions, the first being the clean development mechanism in which members of the original 37 countries to invest in developing countries, for example installing solar panels and energy efficient boilers. The second mechanism to reduce emissions is the joint implementation mechanism; this is when the original members invest in each other's country where it is easier cut costs [UNFCCC. int, 2011]. Appendix H In regards to the environment, government intervention could have been avoided as no one owns the property right to things such as air.

Public goods are free goods available to everyone and include clean air, clean water, and biodiversity; these are mainly non excludable and non rival goods. These public goods have no property rights and thus the business

and household sectors do not put enough emphasis on these goods and they often face a collective action problem. So if no one owns these, why should an airliner have to pay for pollution costs as they cannot be technically accountable to anyone? As there is no single owner of the air that is being polluted airlines could argue that it is not their responsibility and so why should they be forced to pay the full social cost.

The problem of corporate social responsibility then arises; this would argue the blame for the pollution lies with the airlines as they provide a chunk of air pollution. After undertaking a wide-ranging consultation of stakeholders and the public and analysing several types of market-based solutions, the Commission concluded that bringing aviation into the EU Emissions Trading System (EU ETS) would be the most cost-efficient and environmentally effective option for controlling aviation emissions. [European Commission Climate Action, 2011] Any form of taxation will not work as these measures have failed to work in the reduction of emissions.

One example is the car industry where despite the heavy taxes; the number of car owners across Europe continues to increase. Taxation on air transport will not have any effect on the emission of greenhouse effects but will instead have an adverse effect on the growth within the European area. Also governments putting emphasis on the aviation industry which produces less than 2% of EU emissions means that the main reason for intervention is not an environmental factor. It is unclear as to the reason why air transport is a priority in the ETS instead of larger greenhouse gas producing industry.

The impact is so small that if household heating had to improve by 15%, it would cancel out the effect of the aviation industry. Ethically, government intervention was the right way forward as leaving it to the private companies would not have proved effective as their aim is to keep private costs to a minimum. Market failure is bad for your health but social injustice is worse. [Oxford Journals. 32 (1), p12-13]. It is easyJet's duty to abide by any government law. A number of recommendations have been put below as to how the company can best prosper with these new conventions. Appendix I

Low Cost Characteristics ??? Low cost airlines offer a pricing strategy on a first come first serve basis and this means that the passengers who book earlier pay less. Smith, (No Date) Passenger service costs are lower because there is no free food. Sales and reservation and commission cost lower because virtually everything is done online. The number of staff on board an aircraft is reduced as they are not needed due to not serving food. Smith, (No Date) Appendix J Currently the aviation industry is not included in any of the 12, 000 facilities that are included in the trading scheme.

However, from the start of 2012 there will be a cap on the CO₂ emissions from all international flights that arrive or depart from any EU airport.

Airlines will receive the same permits and caps that the previous 12, 000 facilities received. These firms will then enter the carbon market where they can buy or sell permits, whichever maybe the case. If the company finds itself with an excess amount of permits they can choose to put them into the market or to simply keep them to cover future emissions. If the airline is in need of more permits they will need to enter the market and purchase the number of permits they require.

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The firm should also consider investing in alternative technology that will reduce their emissions efficiently. They can also earn emission credits by taking part in the clean development mechanism. [European Commission Climate Action, 2011] The aviation industry has begun to explore new fuels e. g. Bio-fuels. It is out of necessity that new fuels are being researched as these are considered more greener compared to oil. There is currently research into using algae as a bio fuel and into other techniques to make aircrafts more environmentally friendly.

Some improvements have already been made through the industry ??? reduced fuel consumption and passenger-friendly cabins [Commercial Aviation Report, 2007]. Appendix K Oil has always been a finite resource; it was always known it will run out at one time or another. As we approach this time the cost of oil and fuel for the aviation industry will increase as oil becomes rarer. In this time it will be budget airlines that prevail and will continue to operate irrelevant of oil prices. It is their fundamental principle that will pull them through the rising oil prices, to deliver the basic minimum a consumer needs and to charge extra for add-ons.

Budget airlines have a way of finding ways to cut costs in non essential places, they will continue this practise and will eventually gain the competitive advantage over others in the industry. For those companies who exceed their permit limit will have to pay a fine, to give up or purchase extra permits to cover their emissions. [John Walker and Amrit MacIntyre, 2008]

Appendix L * The Emirates A380 burns up to 20% less fuel per seat than other large aircraft * This is the most significant advancement in reducing fuel burn and emissions in four decades. Low fuel burn means lower CO₂
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emissions. The A380 produces less than 75g of CO₂ per passenger kilometre, almost half of the European target for cars manufactured in 2008. * Emirates A380s will progressively feature digital inflight magazines, entertainment guides and shopping catalogues, saving 2kg per seat or almost one tonne per aircraft. * Emirates A380s, which offers more space per passenger in all classes, will also meet ICAO's gaseous emissions standards by a substantial margin. * We will comfortably meet current Stage Three and proposed Stage Four noise level standards. Our new Emirates A380 maintenance facilities in Dubai are state of the art, efficient buildings. * A380s feature lightweight materials that account for 25% of its structure. * Our emissions components ??? such as NO_x ??? will be well under the regulated 'cap four' rule * Emirates is working with Airbus to further reduce weight of our future A380s. * Larger aircraft mean less take-off and landings (in passenger terms, some Emirates A380 versions would be the equivalent of flying up to seven smaller aircraft types). Emirates average fleet age is less than half that of many European airlines, meaning newer technology and efficiency breakthroughs characterise our aircraft. Appendix M The aviation industry has begun to explore new fuels e. g. Bio-fuels. It is out of necessity that new fuels are being researched as oil is a limited resource. There is currently research into using algae as a bio fuel and into other techniques to make aircrafts more environmentally friendly. Some improvements have already been made through the industry ??? reduced fuel consumption and passenger-friendly cabins [Commercial Aviation Report, 2007].

Appendix N Graph Adopted from: The Economist. (2011). Budget airlines: In the Cheap Seats. With traffic expected to slow, low-cost air carriers are

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getting fancy, p1. The graphical illustration shows the number of passengers carried by budget airlines are growing but its set to decline from 14% in 2009 ??? 2010 to 6% by 2013 [The Economist, 2011]. With fewer consumers entering the market, companies have to think of other ways to make money from existing customers. easyJet have approached this by increasing frequency on their routes and using more primary airports.

Customer satisfaction will now become an even greater part of the aviation industry with features such as priority boarding and loyalty schemes, also the trivia of losing luggage should become a thing of past. “ The low-cost carrier market used to be about fast growth and uncomplicated strategies,” says Keith McMullan, of Aviation Economics, a consultancy. “ Now it is about slow growth and complicated strategies. ” [The Economist, 2011] Reference

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