CRITICAL ESSAY 9

COMPETITION POLICY & ANTI-TRUST

The broad objective of competition policy across different jurisdictions is to prohibit anti-competitive business conduct and maintain markets that are conducive to efficient economic performance. In the past two decades the academic study of competition law has witnessed an increased use of economic concepts (discussed later in this chapter) and modes of reason. In particular the use of economics to provide the reason underpinning legal rules and judicial decisions has been in evidence in competition policy.

Perfect competition

Economists and competition lawyers in searching for a model of how the economy works and how to assess anti-competitive business conduct use perfect competition as a useful starting point. In modelling a perfectly competitive environment, simplifying assumptions are made vis-a-vis prices are exogenous (no one firm can control market prices); all firms have access to all relevant information necessary to inform their decisions about production and consumption; firms can sell unlimited amounts at the market price and each firm's perceived demand curve is perfectly elastic though the industry demand curve is downward sloping. To make the latter assumption plausible it must be the case that in all markets there are large numbers of buyers and sellers. This is very often not the case in reality. Another important assumption is that in the long run there is complete freedom of entry and exit in every market. This assumption assures that in all industries, in the long run when all factors can be varied, economic profits will be zero. But entry restrictions do exist in many markets and the raison d'être of competition policy is to analyse the extent of entry restrictions (that is, foreclosure) in a market.

Market failure & dead-weight loss

Competition policy is concerned with the welfare implications of a world that is characterised by perfect competition. In a perfectly competitive world, a (Pareto) efficient allocation of resources occurs in which it is not possible to make anyone better off without making another person worse off. The premise on which competition policy is established is that the market system does not deliver Pareto efficiency in all cases. This is due to market failure which is essentially a failure that causes one of the assumptions underpinning the perfectly competitive model to be false. This in turn leads to the free market arriving at a distribution that is not Pareto efficient.

There are four major sources of market failure:

1. Public goods.
2. Externalities.
3. Informational asymmetries.
4. Imperfect competition.

The latter is germane to competition policy analysis. In imperfectly competitive markets the assumption that each firm takes prices as exogenous is no longer true. Look at the case of newspapers in the UK and clearly one can observe how the Murdoch group can change the price of The Times. In an imperfectly competitive market the firm realises that it faces a downward sloping demand curve (that is, consumers will buy more if the price falls) and can then choose both the quantity that it wishes to sell and the price it will charge. If there is one seller, we refer to the market as monopolistic whilst if there is a single buyer the market is termed monopsonistic. If there are only a few sellers, a market is termed oligopolistic. In a monopoly situation the single seller faces the market demand curve and can exploit this to its own advantage. By restricting output the monopolist can raise total revenue and profits. The welfare implications of monopoly is that less of the good is produced and that that is sold to consumers is at a higher prices than in a perfectly competitive situation. In doing this the monopolist imposes a dead-weight loss on society, that is, any gains to the monopolist are outweighed by the losses imposed on society.

In many markets there is room for a small number of (large) firms. This is the case of an oligopolistic market, examples include the UK brewery market, the US automobile market or the world telecoms market. Here the small number of large firms realise they have market power but are constrained by the reactions of their competitors. Each firm then acts in a strategic manner. Mergers may take place, for example, currently with BA and American Airlines and in 1996 the breweries Scottish & Newcastle and Courage merged to form Scottish Courage or the firms may form a strategic alliance. Another form of imperfect competition is monopolistic competition which is a market structure characterised by product differentiation by such variables such as location and advertising. This gives each firm some market power. An example of a monopolistically competitive market can be found in the retail sector where there are many competitors but only a few in any given area in direct competition with each other.

**Potential competition**

The doctrine of potential competition is implicit in the theory of contestable markets which can be viewed as a generalisation of the theory of perfectly competitive markets. Contestable markets like competitive markets exist when there are no barriers to entry or exit. However contestable markets, unlike competitive markets may be highly concentrated. Baumol has argued that contestable market performance will be competitive in the sense that a cost efficient industry structure will evolve and each firm will earn zero economic profit in the long run. This outcome is guaranteed by the absence of barriers to entry or exit. Since a contestable market is subject to exit and entry, entered firms will be
compelled to charge prices which reflect their costs of production. Without barriers to entry, potential competition will insure competitive performance even in highly concentrated industries.

The main policy implication of contestable market theory is quite profound. High industrial concentration (exists when a few firms have most of the market share) does not necessarily indicate poor market performance. Rather high concentration may well be warranted by economies of scale and of scope. If highly concentrated markets are contestable they will not require government intervention to ensure efficient performance. Contrast this with Demsetz' point that above average profits earned by a large firm are due to their superior efficiency and are not due to collusion. In other words, the barriers to entry as described by Bain are not responsible for the high profits observed in many concentrated industries.

The Chicago School

The Chicago school is in fundamental disagreement with the more traditional (Harvard) school of thought which emphasises concentration in any competition policy assessment. In particular the Chicago school rejects the concentration-collusion doctrine and question the existence of barriers to entry, other than those created by government. They have reversed the causality implied by the more traditional model. In arguing that conduct determines performance, the Chicago position would suggest that the competitive process can result in a variety of market structures, some unconcentrated while others are highly concentrated, both with efficient industry performance.

The policy implications of the Chicago school are different from the traditional school. Firms that have gained a dominant market position should not be presumed guilty of monopoly abuse. Rather they should be regarded as innovative leaders of industry, an argument that could be made in Microsoft's defence. The dropping of the 1978 conflict of the US Federal Trade Commission against DuPont, in which the company was charged with attempting the monopolise the titanium dioxide market, was evidence of the Chicago influence on anti-trust. The Reagan administration also dropped the prolonged case against IBM. The latter decision was commended in one respect, in that it would be foolish to penalise superior efficiency of any industry in a market where international competition is so intense. This is an important point, given our discussion on global competitiveness in Essay 11.

Williamson contends that collusive price agreements are, except in special circumstances, virtually impossible to reach. This suggests the need to reconsider the usefulness of the legal prohibition against price fixing. Many scholars argue that successful agreements to restrict output and raise prices are self destructive. The Chicago position in particular would suggest that collusive behaviour designed to restrain output and raise prices may be a rare thing in an
economy. Given this hypothesis new approaches to understanding oligopoly theory have been advanced recently including [i] the development of non-co-operative game theory to examine the behaviour of firms in a non-collusive environment and [ii] examining the motivation behind collusive efforts.

**Inter-firm contracting**

However, from a strategic perspective, the avoidance of price wars is certainly a compelling reason for business to collude. Price wars can be expensive in terms of the increased volume of sales required to compensate for lowering prices in some markets. Some defendant firms in earlier US cases argued that the purpose of their agreement was simply to avoid a price war, arguing further that their prices were reasonable and reflected only legitimate costs of production. However, a per se rule against price fixing was thereby established in US jurisprudence which has since influenced EU legislation and has influenced the debate on how pricing practices are enshrined legislation across many jurisdictions.

Interdependence is a fact of life amongst firms and telling interdependent firms though a legal mandate to avoid one another's existence in rather pointless. If the market fails to co-ordinate behaviour some form of inter-firm co-ordination will be required to avoid price wars. Price fixing, price leadership, market sharing, cost-plus pricing and mergers are all forms of inter-firm co-ordination or contracting. The concern often expressed is that the mechanisms designed to avoid price wars may be used to artificially increase prices and profits at the expense of the consumer. Posner would disagree that some co-ordination is necessary among oligopolies; rational oligopolies will normally decide not to collude but expand their output until competitive returns are realised. This may be easier said than done, given the zero-sum assumption reviewed earlier.

**Products and markets**

In this essay, we attempt to examine the overlap between competition policy and the strategic behaviour of the players. Having just looked briefly at the essence of competition policy, presenting a picture which looks at the particular influence of microeconomic principles, we now consider two inter-related issues viz the level of price (and how that level is arrived at or indeed maintained) and the level of market shares. The latter is relatively easier to address once we can agree on the definition of the relevant market. Once we have the relevant market, we can then proceed to identify the competing products and assemble the respective market shares of the rival players for computation. The computation is important and of crucial significance as we proceed to define concentration and dominance in a product-market.
Relevant market

The definition of the relevant market provokes an interesting debate both on the economic side and indeed on the legal side, where precedents have been set to define what constitutes a relevant market. We alluded to the debate on whether or not a market exists for branded products in our examination of the criterion of substitutability which determines whether or not any two products are in the same market. The products are in the same market if the cross-price elasticity is positive and greater than 1, so that any increase in the price of one product will lead to an increase in sales of a second product. The consumer therefore views both products as (demand) substitutes. However there is also supply substitutability, which looks at the production-side of the product. So, for example, the market is pet food, not dog food or cat food separately, because of economies of scope in the production supply chain, each food type can supply substitute for the other in the production process.

The interplay between supply side substitution and demand side substitution is particularly important. On the demand side, one of the great oversights of antitrust analysis is the dearth of econometric estimates on cross price elasticities which are necessary to determine product substitution. One reason proffered is the difficulty in accessing dis-aggregated data and the unreliability of such data, if available. In the absence of such data, we focus on the more aggregate market definition from an economics perspective. We should not replicated a line of reasoning which first appeared in a 1962 US antitrust case Brown Shoe, where the Court did not use the idea of cross-elasticity of supply. In this sense, the Court did not explore the extent to which production capacity for making men's shoes could be modified to make (say) children's shoes, following small changes in price. Evidence of high cross-elasticity of supply would suggest the relevant market should have been `all shoes'.

One would have thought that the EU in its 1978 United Brands case would have concluded that bananas were part of a much wider fresh fruit market. In the event the Court took a quite different view and argued for the banana to be a separate market since amongst other things it argued that a very large number of consumers, having a constant need for bananas, would not be noticeably enticed away from the consumption of the bananas by the arrival of fresh fruit, following small changes in price. The EU relied on demand-side evidence. On the demand side, goods are treated as being in the same market if they are close substitutes which implies that a small increase in price by one of the products would lead to a loss of sales of the other product.

On supply side, there are, as always, two relevant characteristics viz technology and entry conditions. On the supply side, the products can be treated in the same market if technology and entry conditions are such in the market as to allow firms supply other products and to switch production readily and to supply the market in question in response to a change in price. High elasticity of supply would
suggest that `all products' should (from first principles) be treated as being in the same market, because a small increase in price of one product line would readily lead to an increase in production of that line from capacity [that is, production on the production function] which had previously been producing a related line. Supply substitutability in microeconomic theory is not about switching output in the plant, it is about the increase in production from capacity (which is precisely what elasticity of supply is meant to measure).

**Bain's concentration ratio**

Having agreed on a definition of the product market, the next stage is to compute market shares. We consider the illustrative case of five players with each at 20%. First observation is that the market shares are exhaustive: we can account for the 100% of the product market which is a strong assumption. Also we can identify the 5 players and assuming there is no cross-shareholding or joint acquisition, we have five uniquely different players. The first and less reliable concentration measure is the Bain concentration measure, CRn which is the sum of the market shares of the top n players in the market.

So in our example, the CR3 = 60. For a market to be defined as concentrated, a CR3 > 75% would be the threshold although in some jurisdictions CR4 > 40 can be used. If we define the first set of 20 shares, a pre-merger characterisation of the market, post-merger the number of players reduces to 4 and the shares differ, giving a CR3 > 75% so in this case the market is concentrated. What is important here is that a merger per se created a higher degree of concentration in the market. This can explain why it is that nearly all jurisdictions police merger activity.

The premise that is championed here, is that concentrated markets are less competitive, prices are higher (than in unconcentrated markets) and on average, there is a greater probability of finding players with larger market shares. Ironically, we have argued in this series of essays, that in oligopoly markets, the quintessence of a concentrated market by definition, there is an incentive for players to avoid price wars. But that does not preclude price differences. We can accept that price differences do not equate with competitive prices, but what does? There is no standard of competitive prices and there is absolutely no reason why competitive prices have to be at the low end of the spectrum.

The only assurance from the Neo-Classical theory is that competitive prices are less than monopoly prices. Granted, in concentrated markets there is a greater awareness of each others interdependence, but this should not be a presumption of illegality. Nonetheless it is incumbent upon competition agencies to monitor behaviour in concentrated markets while be cognisance of strategic behaviour that does not have the intent of anti-competitive behaviour. One could argue that
concentrated markets lead to higher than average prices; but here is a fallacy, if one opins that mergers leads to higher concentration levels that mergers per se contribute to higher prices. There may well be other structural or behavioural attributes in that market that could equally account for the presence of higher than average prices (post-merger).

A weakness of the CRn measure is that it is information deficient, if one compares a CR = 55, there is no information on how the shares are distributed amongst how many players. It could be 50, 3, 2 or 20, 20, 15 and it is more than likely that 50, 3, 2 is more concentrated because of the presence of a dominant firm. Also the Lancaster precedent of equity across market shares. The latter is not about equal market shares but, that post-merger the divergence between first and third players is less; one looks at the difference in market shares and a minimal difference criterion is supportive evidence against enjoining a merger. Also the issue of dominance what identifies a particular market share to define a dominant firm, usually above 40%, although it depends on the type of product market, the history of entry, innovation currently in the market and a number of players criterion and legal precedent.

**HHI concentration measure**

To try and overcome this deficiency, an alternative measure, the HHI is applied. And in the example above, the market shares are squared and then aggregated and a market is deemed to be concentrated if the HHI falls within the boundaries: 0.18 < HHI < 0.22. The support for the HHI is that it also captures the direction in concentration [as with the CRn] and performs better as a measure on the magnitude where we can identify moderate degrees of concentration as measured in scales of 50 points. So concentration is a matter of standardised definition across most jurisdictions: a product market is concentrated, if CRn > 75% and if 0.18 < HHI < 0.22.

In 1982, two US breweries, Pabst and Heilman proposed a merger and the HHI in the beer industry was 0.177. Before the merger each firm had 7.5% share - after the merger the combined share of 15% would raise the Index by 112.5 so it was challenged by the Department. In 1984 the same companies reapplied to the Department and Pabst agreed to sell four of its brands [30% of production] and one brewery to a third party. The sale brought the merger within the guidelines and the Antitrust Division dropped its objection.

An analogous situation arose under EC legislation in the 1992 merger between Nestle and Perrier. The Commission had concluded that a dominant position would result from the proposed merger. Prior to the bid, Nestle gave BSN, the second largest supplier of bottled mineral water in France after Perrier, the option to acquire Volvic one of the products in the Perrier portfolio. The Commission found that if Volvic stayed with Nestle, that Nestle would have a single firm dominance in France and if Volvic was discharged to BSN, that Nestle and BSN
would have an oligopolistic dominance with 94% of the French bottled mineral water market. Eventually the dominant position was removed when Nestle undertook to divest 20% of total capacity to a third party and the Commission offered a `declaration of compatibility' with common market principles and approved the merger. However, the Commission can revoke its decision under Article 8(5)b of the EC Merger Guidelines.

Dominance

A related issue is the definition of dominance which is linked to the (individual) market shares of the player. There is a need for a market share threshold above which firms are defined as dominant, more because of the `abuse of dominance' charge that can be levelled against an individual player. There are two aspects of an abuse of dominance viz disadvantage rivals and foreclosure. If a dominant firm engages in predatory pricing this may have the effect of disadvantaging rival players in the market. And dominant firms may be in a better position to erect barriers to entry which have the effect of foreclosing on the entry of potential entrants.

Predatory pricing

Let us take the first issue of predatory pricing which focuses on low prices and the accusation that the dominant firm is charging low prices with the intent of disadvantaging the rival competitor. This is an interesting perspective, in that the consumer may benefit from the low price, assuming quality and after-sale service is not diminished (read later where both quality and after-sales service are defining competition in a global sense). A difficulty arises 1. assuming that predatory pricing is the exclusive preserve of a dominant firm, which it may not, and 2. identifying how low a price has to fall for it to be predatory. With respect to 1, if dominance can be disproved, then ipso facto there is no predation. With respect to 2, three low prices could be illustrated, and while the lowest is predatory, the other two may come within an effective costs argument.

In other words, does a cost competitive player, that translates economies of scale to the consumer as lower prices, have to be penalised on a charge of predatory intent of lowering prices. To add some degree of respect for the concept, the Areeda-Turner rule imposes a floor on price, below the AVC and the price is predatory. One important argument here, is that if the costs are industry-wide costs, then the firm who has the higher than average costs, will complain about the (or any) lower prices when, in effect, that plaintiff may be less cost-effective than the average firm in the market. An efficiency defence for a firm does exist but in can co-exist with the intent argument to disadvantage.

As pointed out earlier the level of price is the second important attribute in the application of competition policy. The historical background to antitrust, has created a dislike of monopolies while monopoly price is assumed to be higher.
The opening remark is that the monopoly price is higher in theory than a competitive price, which in theory is lower than a monopoly price. The issue really for antitrust is to examine why the price is different not higher - it may be due to a deliberate attempt to fix prices, a deliberate attempt to increase profit margins with costs falling or it may be an inefficient large public utility monopoly that carries too many cost overheads. Whatever the reason the attempt to engage in price-fixing by players in a concerted way in the market is illegal. It is the element of conspiracy to set (fix) prices, that has to be proscribed, rather than the level of price per se. And whether or not there are trade associations conspiring to rig the market price. The competition issue is to unearth proof of the existence of an agreement rather than assemble data on the level of prices per se. What is the relevant price? And what is the relevant price is a strategic world of price differences? The view that is presented here is that too much effort can be wasted focusing on price when non-price activity may equally support an argument for breach of competition laws.

Public interest

Competition policy is concerned with the market failures associated with imperfect competition. Specifically, in imperfectly competitive markets there is an incentive for competitors to collude in their combined interests and against the interests of consumers and society generally. Competition policy is instituted to ensure that any co-operation that is undertaken by competitors acts in the interests of society and not just in the particular interests of the firms themselves. In addition, competition policy has a role in ensuring that monopolies that do exist are natural, in the sense that the market could not bear more competitors. However, many positions of monopoly power exist because the incumbents can fend off entry in a manner that is not in the interests of society generally. In this instance competition policy can help to ensure that if economic profits are made and entry is possible, no behaviour on incumbent firms can foreclose such entrants.

Most microeconomics textbooks continue to espouse the concentration-collusion doctrine and the static (perfect competition) perspective. There is need for a change. The premise on which competition policy rests is that price fixing and market sharing arrangements, do not benefit the consumer (dead-weight losses occur). The economics of the 1990s, however, emphasises the goal of economic growth, innovation and competitiveness. The ultimate purpose of competition law, which is to maintain a competitive environment, remains intact. However the definition of what constitutes a competitive market is undergoing fundamental change in economics. The competitive process is increasingly regarded as dynamic rather than static in nature and the long standing concern of EU competition law and US anti-trust with regard to static competitive market structures may have to change. In this environment, the role of competition policy will have to change to accommodate the competitive process, with its hallmarks of strategic alliances, consolidation and non-price competition. In other words,
with strategic behaviour amongst players, a scenario could easily arise where antitrust analysis lags behind the sophisticated behaviour of players in a market.