Economic Policy #10

Competition Policy

Competition policy

- Theoretical foundations
- Abuse of dominant market position
  - market concentration measures
  - the concept of relevant market
  - the ways of abusing of dominant position
- Cartel agreements
- Merger controls
- Price controls and natural monopoly
- Public Aid

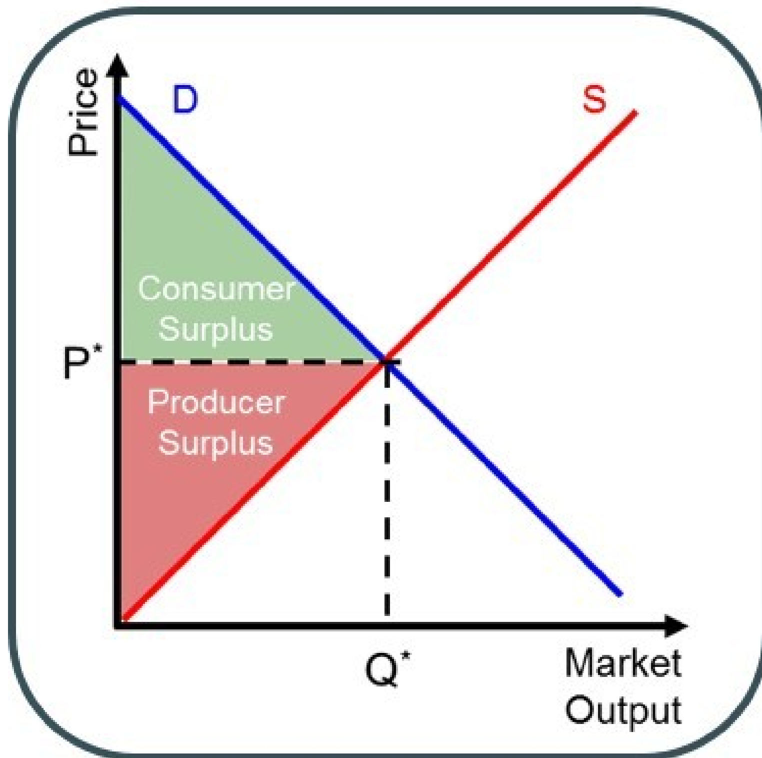
The aim of competition policy

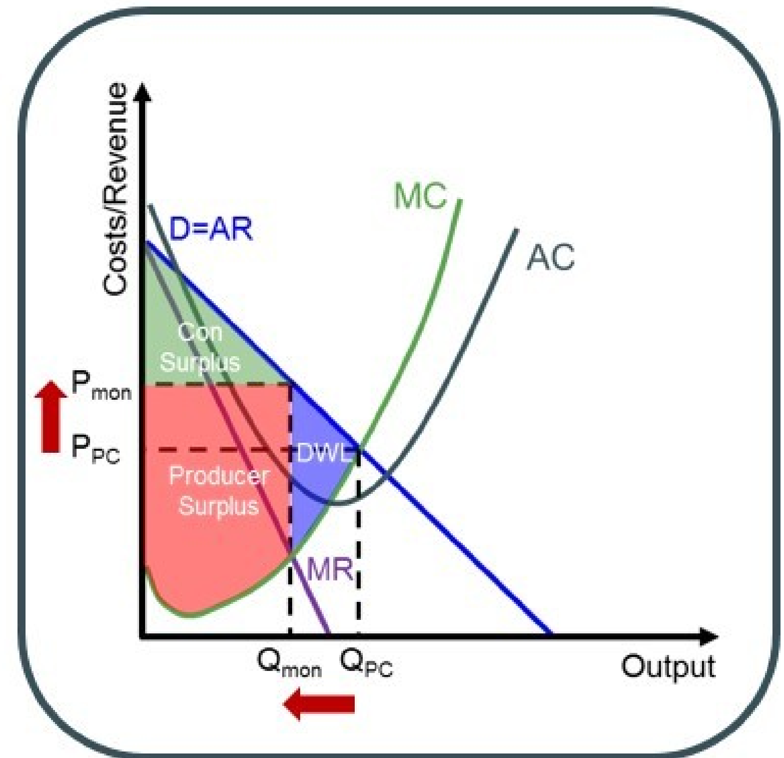
- The aims of competition policy are to promote competition; make markets work better and contribute towards improved efficiency.
- Competition policy aims to ensure:
  - technological innovation which promotes dynamic efficiency in different markets
  - effective price competition between suppliers
  - safeguard and promote the interest of consumes through increased choice and lower price levels

Forms of market competition

Models of Competition	Number of buyers	Number of sellers	Nature of products	Barriers to entry and exit
Perfect competition	Very large	Very large	Identical products	None
Monopoly	Very large	**One**	Single product	**Very large**
Monopolistic competition	Very large	Large	Minimum differences	None
Oligopoly	Very large	**Very few**	Large differences	**Large**

Static inefficiency of imperfect competition





Surplus Maximised

Welfare Loss

Who is in charge?

- no multilateral competition authority
- US
  - long tradition
  - focus on dominant positions and mergers and aquisitions (M&A’s)
  - federal government and courts in charge
- Europe
  - national governments and EU Commission
  - subsidiarity principle: EU Commission deals with larger and cross-border cases

Competition authorities

Competition authorities can hurt companies by:

- blocking M&A's, imposing fines and ordering the repayment of subsidies
- negatively affecting the valuation of companies by financial markets
- involving the company in a long and expensive battle with the competition authorities
- causing severe reputational damage

The areas of competition policy

Competition policy encompasses five main areas:

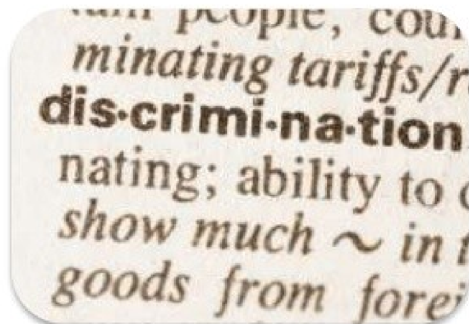
- dominant market position abuse
- cartel agreements
- merger examination
- price regulation
- state aid and public procurement

Anticompetitive behaviour

Price fixing and market sharing

Predatory pricing and limit pricing

Charging excessively high prices



Refusal to deal / discrimination

Patent misuse

Protectionist policies limiting overseas trade

Industry concentration

1. ***Concentration ratio*** (CR): measures an industry's concentration by examining the share of output controlled by the largest four firms in that industry.

There is a problem with CR.
Example: What does exactly mean if CR = 100?

Industry concentration

2. ***Herfindahl-Hirschman index*** (HHI) is found by summing the squares of the market shares of all firms in industry.

Advantages over the CR(4) measure:

- measures how “concentrated” the market is
  – large market shares => squared => HHI increases exponentially (rather than linearly)
- uses data on all firms

Dominant position

The ***dominant position*** must not be assessed on the sole basis of the market share held, but rather in relation to the effective *capacity* of a firm

- to prevent effective competition being maintained on the relevant market during sufficiently long period of time
- by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of the consumers

Relevant market

- ***Relevant market*** comprises a product or group of products or services (interchangeable/substitutable) and the geographic area in which these products are produced and/or traded.

- Two components of relevant market: the product market and the geographic market.

The relevant product market

The relevant product market is determined according to three criteria:

- demand-side substitution
- supply-side substitution
- potential competition.

Factors influencing supply/demand: transportation costs, fidelity of customers, long-term contracts, administrative costs, start-up costs etc.

The SSNIP (or hypothetical monopolist) test

- *Small but Significant non-transitory Increase of Price*
- The relevant market contains all those substitute products (and regions) which provide a significant competitive constraint on the products and regions of interest: therefore, if a small but significant (5/10%) non-transitory increase of price 'pushes', 'encourage' the consumer (or the supplier) to look for (or to provide) a substitute, all those goods (or services) which are easily substitutable, on the demand and supply side, belong to the same market.
- A problem in non-merger cases: *The "Cellophane Fallacy"*

Implementing the SSNIP Test

- The very reliance on a hypothetical (monopoly) situation means that there exist no data that would allow for a literal application of the test.

- The tools that can be used to implement the test:
  - own-price elasticity
  - cross-price elasticities
  - price correlation tests
  - price differences

Geographic relevant market

- The geographic market is an area in which the conditions of competition applying to the product concerned are the same for all traders.
- The same factors used to determine relevant product market should be used to define the relevant geographic market.

Forms of abuse of dominant position

- directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions
- limiting production, markets or technical development to the prejudice of consumers
- applying dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage
- making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connections with the subject of such contracts

Methods of abuse of dominant position

- related to prices:
  - predatory pricing
  - price-squeeze
  - excessive pricing
  - price discrimination
  - rebate systems
- other types:
  - refusal to supply
  - tying
  - exclusive sales or exclusive purchasing agreements

Cartels and other horizontal agreements

- *Horizontal restriction* of competition refers to an agreement or procedure for limiting competition between businesses that operate on the same production or distribution level, i.e. actual or potential competitors.

Prohibited activities

Especially these agreements and practices are prohibited, which:

- directly or indirectly fix purchase or selling prices or any other trading conditions
- limit or control production, markets, technical development, or investment
- share markets or sources of supply
- apply dissimilar conditions to equivalent transactions with other trading parties, or
- make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which have no connections with the subject of such contracts

Cartels in practice

The most common cartels that appear in practice are:

- price fixing and price recommendations
- market or supply sharing or limiting production
- bid rigging (collusive tendering)
- information sharing

Merger control

The aim is to secure the competitive structure of the markets by intervening where necessary ex ante with concentrations significantly impeding effective competition.

Merger control subject to the Competition Act:

– merger of two or more competitors previously independently active on the market
– acquisition of an enterprise of another competitor or a substantial part thereof on the basis of an agreement
– acquisition of control (directly or indirectly) over another competitor
– foundation of a concentrative joint venture.

Price intervention

- A number of prices are affected by regulators who may impose a pricing formula on suppliers.
- Examples: fares in public transport, postage stamps, water, electricity bills etc.
- It’s a way to curtail the monopoly power of „natural monopolies“ or dominant firms preventing them from making excessive profits at the expense of consumers.

Downsides of price regulation

- reduces profits – less money for capital investment
- may dissuade new entrants
- firms might raise prices in other ways

Alternatives?

- measures to reduce entry barriers in an industry
- higher taxes on monopoly profits

State Aid

- By giving certain firms or products treatment to the detriment of other firms or products, state aid disrupts normal competitive forces.
- Under current EU state aid rules, a company can be rescued once.
- Any restructuring aid offered by a national government must be approved as being part of a feasible and coherent plan to restore the firm's long-term viability.
- Government aid designed to boost research and development, regional economic development and the promotion of small businesses is normally permitted.

Box. Possible causes of regulatory failure in competition policy

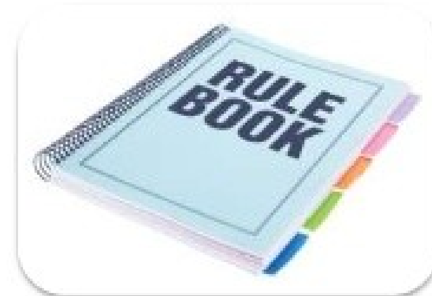
Regulators may limit innovation in fast-growth markets

Capping prices might prevent new firms entering a market

Regulation becomes bureaucratic & costly

May lack the powers to be truly effective in protecting consumers

Regulator might be "behind the curve" with new technologies



Frequent rule changes can stifle business investment