Economics of competition and competition policy

References

- Faull & Nikpay: The EC Law of Competition. 2nd Ed. Oxford University Press, 2007
- Bellamy, C., Child, G. European Community Law of Competition. 6th Ed. London: Sweet & Maxwell, 2008.
- European Commission - Competition http://ec.europa.eu/competition/index_en.html

Competition and economics

- Competition law is economic law – need of coherent economic methodology as a supplement to the legal rules.
- Competition policy is economic policy concerned with economic structures, economic conduct and economic effects.

The aims of application of economic principles in competition law

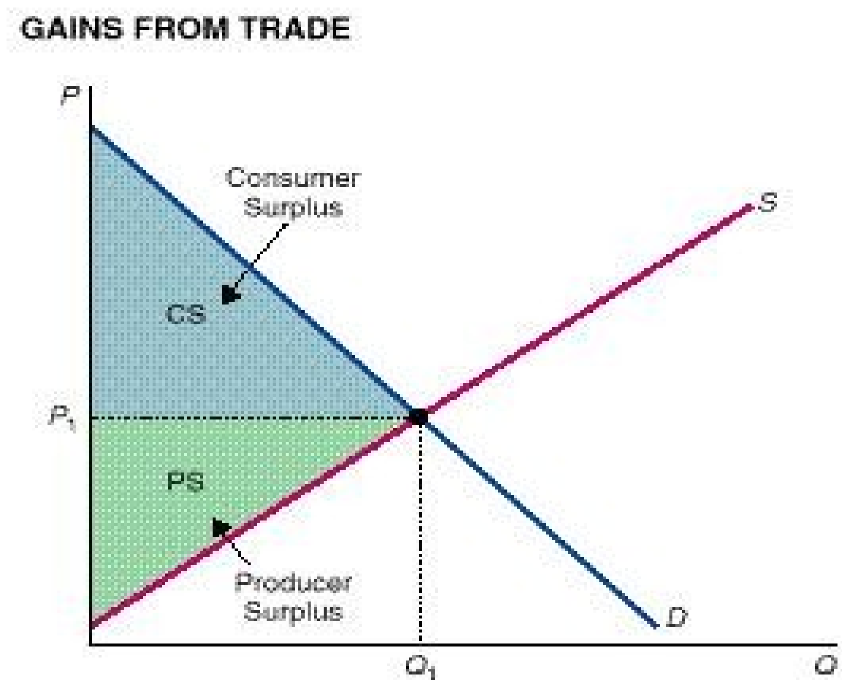
- to ensure the compatibility of competition policy with economic learning
- to provide a coherent framework of analysis,
- to provide relevant lines of reasoning,
- to identify the main issues to be checked in the context of certain theories of competitive harm,
- to exclude certain outcomes

Basic economic concepts

- consumer surplus
- production costs
  - important for economic analysis of pricing policy of dominant undertaking
- profit maximisation
- economies of scale
- contestable markets
- barriers entry

Consumer surplus (CS)

- The difference between consumers willingness to pay ("reservation price") and price actually paid

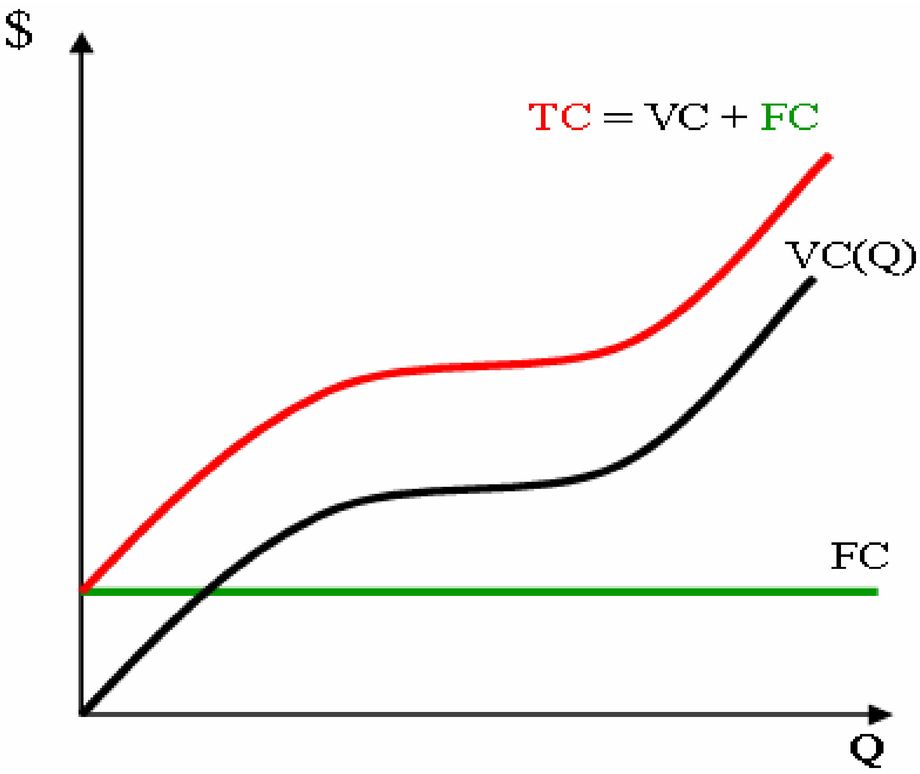


- **Producer surplus (PS)**
  - Refers to the variance between the price in the market which producers collectively receive for their products and the sum of those producers' respective marginal costs at each level of output

Production costs

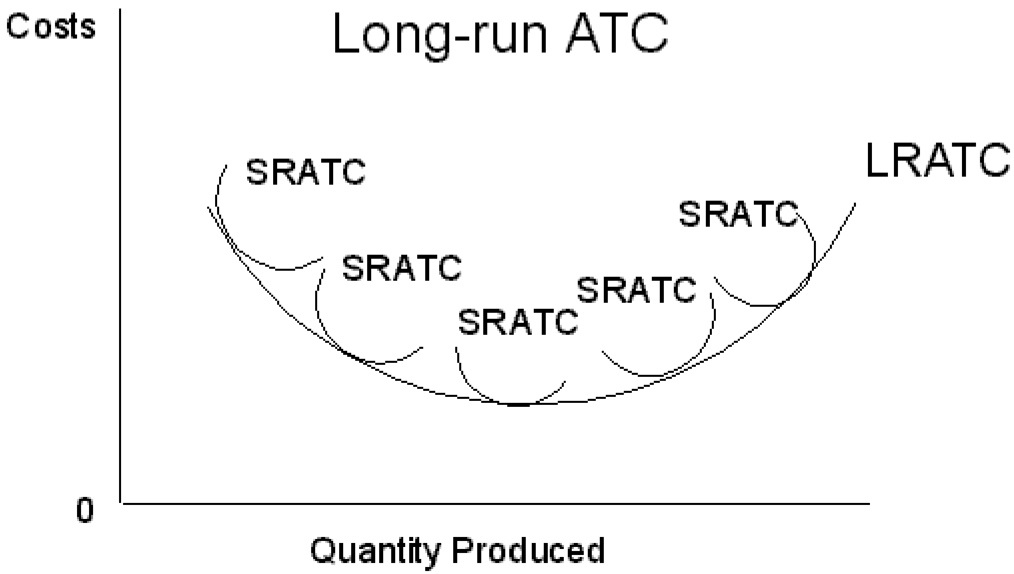
- **Fixed costs (FC)**
  - Remain constant in spite of changes in output, such as management overheads, depreciation, interests and property taxes
  - E.g. rent, machinery
  - In the long term – no fixed costs, all of costs are variable
- **Variable costs (VC)**
  - Varies with changes in output
  - E.g. wages, utilities, materials used in production
- **Total costs (TC)**
  - Comprises sum of fixed and variable costs (TC = FC +VC)

Short run production costs



Long Run Production Costs

- Fixed production factors are also variable (no fixed costs in long term)



Production costs

- **Average costs (AC)**
  - Production costs per unit of outputs
- **Marginal costs (MC)**
  - The change in total cost that arises when the quantity produced changes by one unit
- **Sunk costs**
  - Costs that have been incurred and cannot be reversed
  - e.g. costs spending on advertising or researching a product idea
  - They can present a barrier to entry
    - the potential entrant would have to incur a similar costs which would not be recoverable if the entry failed → they can deter new entrants

Price cost tests

- Important for an examination of monopoly pricing policy → price cost tests help to distinguish between abusive conduct and competition in merits
- Example:
- **Predatory pricing**
  - *„prices **below average variable costs** give grounds for assuming that a pricing practice is **eliminatory** and that, if the prices are **below average total costs** but **above average variable costs**, those prices must be regarded as **abusive** if they are determined **as part of a plan for eliminating a competitor**“*

    European Court of Justice, Case C-202/07 P France Telecom SA v. Commission
  - Recoupment test – considers whether the dominant undertaking has a reasonable prospect of recouping its losses (required under the US Case law in order to prove the abuse of predatory pricing)

Profit maximization

- The goal of the company is to maximize its profit

- Profit is maximize when: **MC** (marginal costs) = **MR** (marginal revenues = the increase in revenue from selling one more unit of a product)
  - additional costs of producing one extra unit of output are still covered by the additional revenue earned by this extra unit of output
  - this rule hold goods for companies with market power as well as without market power

Economies of scale

- The cost advantages that a business obtains due to expansion →increasing capacity lead to economies of scale (the higher capacity reduces the average costs)
- Economies of scale, especially when they are substantial, are important explanation for concentration tendencies in market
- May result from:
  - <u>Indivisibility of certain production factors</u>
    - The bigger truck that transport is more while still requiring only one driver
  - <u>Technical-physical relationship</u>
    - The bigger oil tanker than requires relatively less steel to be built
  - <u>Economies of increased dimensions</u>
    - Larger company that may obtain discounts when buying larger amounts of inputs

Economies of scale

- **Static** internal economies of scale
  - not related to past production
  - important economies of scale – in motor vehicles or other mean of transport sector, chemicals, paper and printing,…
- **Dynamic** internal economies of scale
  - a lowering of cost production over time as a result of experience obtained on past cumulative output (“learning effect”)

Contestability

- Contestable market
  - there are no sunk costs or other entry barriers and consumers are willing to switch quickly, before incumbents can react, to the better offer of new entrants
- The potential competition exists →“hit and run” entry is possible
  - it disciplines the incumbents, even when they have very high market shares
- In practice not many markets are truly contestable
  - entry usually requires sunk costs, incumbents are often in a position to react quickly, that is before consumer loyalty wears down

Economic and empirical analysis (tests) used in investigation of competition law infringement

- Analysis of Price elasticity of Demand
  - Price elasticity of a product = how demand for that product changes with change of price of the product
- Market definition
  - SSNIP test („the test of **Small but Significant and Non-transitory Increase in Price** „) – arises from price elasticity of demand
- Merger simulation – the technique to simulate the impact of mergers in specific markets
  - Information on demand + assumption about the nature of competition in the market

Economics and EC Competition law and policy

- Increasing role of economics in antitrust proceedings →Importance of economic analysis
- Economics helps in evaluating effects and designing structured rules
- Economics help in understanding market dynamics and building evidence

Investigation effects of using economics

- Spell out a logically consistent theory of consumer harm
- Validate that theory empirically
  - Check the realism of the underlying assumptions (ex-ante validation)
  - Check whether observed market outcomes are consistent with the predictions of the theory (ex-post validation)
- Identify alternative pro-competitive motivations for the practice
- Use of established theory, extensions, ad hoc developments
- Develop testable hypothesis

(The role of Economics in European Competition Enforcement and Policy - Damien Neven, Chief Economist DG COMP, European Commission)

The Chief Competition Economist

- A part of the Commission's Competition Directorate General since 2003, and assists in evaluating the economic impact of its actions
- Functions:
  - **Support function** – the CCE gives economic guidance and methodological assistance
  - **Checks and balance function** - the CCE provides the Commissioner with an independent opinion
- The CCE cooperate with academic world:
  - The **Economic Advisory Group on Competition Policy ("EAGCP")**
      - a group of approximately 20 leading academics working in the area of industrial organization with a keen interest on Competition policy
    - Two types of activities:
      - **Opinion on important policy issues**
      - **Annual forum** →he objective is to discuss policy issues and economic methodology in the context of particular cases.
  - *The **Economic Seminar Series on competition policy ("ESS")***

More economic approach to art. 82 (102 TFEU)

- *The objective of Article 82 is the* ***protection of competition*** *on the market as a means of* ***enhancing consumer welfare*** *and ensuring an* ***efficient allocation of resources….*** *First, it is* ***competition****, and not competitors, that is to be protected. Second, ultimately the aim is to avoid consumers harm.*

Competition Commissioner Neelie Kroes speech 2005

- *An economics-based approach requires a careful examination of how competition works in each particular market in order to evaluate* ***how specific company strategies affect consumer welfare****… By focusing on the effects of company actions rather than on the form that these actions may take, an economics-based approach makes it more difficult for companies to circumvent competition policy constraints by way of attempting to achieve the same end results through the use of different commercial practices.*

Report by the EAGCP – An economic approach to Article 82

More Economic Approach

- Why?
  - The aim is to achieve the maximum benefit for consumers from EC competition rules
  - The strict legislatic enforcement of the competition rules in the past raised serious difficulties
  - There was a need to investigate complex cases, which require in-depth fact-finding and rigorous economic and/or econometric analysis.

More Economic Approach

- February 2009 - new legislation which implements the revised approach: **Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings**
  - The guidance paper sets out an economic and **effects-based** approach to exclusionary conduct under EC antitrust law (rather than form-based approach)
  - Rule of reason rather than per se rule

Effect-based approach v. Form-based approach

Effect-based

- Commission would carefully discern competition on the merits, which has beneficial effects for consumers and should therefore be promoted, from competition that is liable to lead to anticompetitive foreclosure.
- Since the focus of the Commission's policy is on the effects on consumers, it should be prepared to examine claims put forward by a dominant firm that its conduct is justified on efficiency grounds.

Form-based

- The form of behavior is important for identifying of anticompetitive conduct.
- The risk that statutory provisions unduly thwart pro-competitive strategies.

Rule of reason v. per se rule

Rule of reason

- It is necessary to prove adverse market effects (conduct may be defended on the ground that adverse effects are outweighed by beneficial ones)
  - \+ authorities distinguish anticompetitive behavior from procompetitive
  - \- difficult evidence, legal uncertainty, decision making is unpredictable

Per se

- The presumption of anticompetitive effect of certain conduct.
- No tools of economic analysis
  - \+ Predictability, legal certainty, easier evidence
  - \- Inappropriate state intervention (regulation can distort competition)