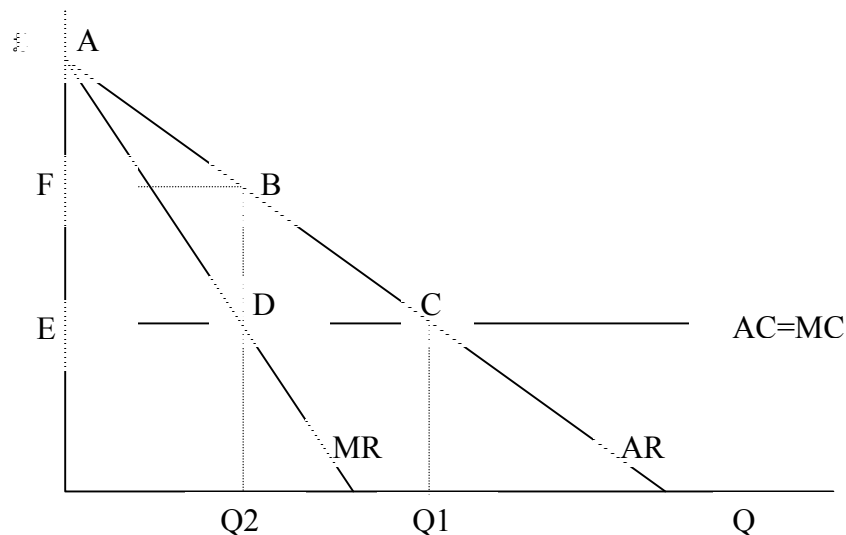


Competition Policy

Theoretical Positions

1. The Classical View

It would be possible to hold to a view that opposed all mergers and monopolies. The argument would be that perfect competition is the optimal industrial structure for capitalism, producing productive and allocative efficiency and maximum consumer choice. Any move away from this ideal is therefore a move away from the social optimum. This is illustrated in the following diagram:



The diagram shows an *industry* under the simplifying assumption of constant returns to scale – hence AC is constant and equal to MC. A perfectly competitive industry would operate at C, with output Q_1 , with every firm taking a price E. Each firm would be allocatively efficient with price = marginal cost.

Suppose that in this perfectly competitive industry the firms begin to knock each other out of the market, until there is only one firm left. Assume that the resulting monopoly has the same costs as the original firms. The monopoly will face the entire market demand curve, AR, and will profit maximise at Q_2 and price at F.

This leads immediately to undesirable welfare consequences. Under perfect competition consumer surplus was equal to the area ACE. Under monopoly this shrinks to ABF. The monopolist has captured the area FBDE of what was previously consumer surplus in the form of supernormal profit. This is area still contributes to

social welfare since entrepreneurs or shareholders are part of society. However, by reducing output to Q_2 and driving up the price to F , an area of consumer surplus BCD is lost. This “deadweight loss” forms the classical argument against monopolies.

Thus, in the classical view, the market power firms achieve through mergers and acquisitions will allow them to restrict output, drive up their prices make supernormal profit and therefore misallocate scarce resources. There is a further likelihood of misallocation: such firms are likely to become complacent – wasting resources on unnecessary costs and failing to innovate.

According to this view, competition policy should restrict the growth of market power, and this means prohibiting mergers and acquisitions and taking active steps to break up companies that succeed in achieving a dominating market share. There should also be laws prohibiting price fixing by firms large enough to collude with others in their industry and so acting together as if they were already a monopoly. Such a competition policy would be relatively simple to implement and transparent to those likely to be affected by it.

2. Criticisms of the Classical View

A number of criticisms can be made of the classical view, arguments that might justify a more pragmatic competition policy, with each case judged on its merits rather than against some hard and fast rule.

- Baumol argued that as far as economic efficiency is concerned it is not the market structure that matters but rather the contestability of the market under discussion. Even a monopoly will be forced to keep prices (and supernormal profit) to a minimum if there are no sunk costs preventing hit and run entrants. Competition policy, in this view, should look at factors determining contestability rather than market concentration ratios.
- In the analysis above it was assumed that the model of perfect competition is a good ideal type of capitalism. This seems pretty unlikely. In reality, even with small scale production there are enormous information issues in any market. Further, product differentiation seems to be the norm. This casts doubt on the starting point of the classical analysis.
- In the move from small to large firms there are likely to be economies of scale. These will *reduce* the average and marginal costs of the remaining firms. The reductions may be so significant as to lead to lower prices than under perfect competition even when monopoly profits are being made. There would then be a deadweight loss from preventing mergers.
- The supernormal profits made by firms with market power may provide funds for research and development, and hence innovation. Restricting the growth of firms may thus end up by restricting consumer choice.
- The classical view ignores the realities of late capitalism. The international division of labour has extended so far that very large scale operations tend (in

a process Schumpeter called ‘creative destruction’) to drive out inefficient or complacent small ones. A blanket ban on mergers would then remove one of the driving forces of efficiency and change.

- This is partly a matter of production – exploitation of comparative advantage through specialisation and the realisation of economies of scale – and partly a matter of consumption. On the consumption side the role of brands in enabling consumer recognition of products and in overcoming problems of asymmetric information has become an intrinsic part of commercial success. Standard brands may offer only a second best quality, but it is a recognisable quality all over the world. Massive expenditure on both advertising and research and development to maintain the ‘newness’ of the brand is then the necessary accompaniment of large scale production.

The UK Competition Policy Framework

A. Mergers Policy

UK competition policy is pragmatic rather than being anti mergers and monopolies ‘per se’. The 1973 Fair Trading Act stipulates that any merger or acquisition involving more than 25% market share in the UK or which involves the targeting of more than £70 million of worldwide assets is eligible for referral to the Competition Commission. At least one of the firms involved must operate in the UK. The Office of Fair Trading is responsible for provisional assessment of likely mergers for investigation.

The OFT then advise the Secretary of State for Trade and Industry who has the final say in whether the proposed merger or acquisition should be *referred* to the Competition Commission. If referral takes place then the Commission conducts an investigation – and must decide whether the merger is in the *public interest*. They may recommend conditions for the merger to go ahead, e.g. *divestments*, or simply that the merger be allowed or prohibited. Their conclusions and recommendations then go to the Secretary of State who is responsible for the final decision.

B. Monopoly Policy

Under the 1998 Competition Act, the Office of Fair Trading may investigate any firm thought to be abusing market power at either a local or national scale. Fines of up to 10% of annual turnover can be levied by the Director General of the OFT for each year of the infringement under the so called “Chapter II” clauses of the Act.

The OFT must first determine whether a firm has a “dominant” market position. This can be either at a local or national scale and is acknowledged to be not only a matter of market share but also contestability. The OFT web site states that “Although it will vary from case to case, as a general rule an undertaking is unlikely to be considered

dominant if it has a market share of less than 40%.” However, having a dominant market position is not in itself illegal. The OFT has to determine that the firm is engaging in anti-competitive practices (such as unfair pricing) on the basis of its dominance before a fine can be imposed.

C. Restrictive Practices Policy

An exception to this pragmatic approach is the treatment of cartel like behaviour – with few exemptions price fixing and other restrictive practices are illegal under the 1998 Competition Act if they threaten to “appreciably” reduce the level of competition in an industry. This is known as “Chapter I” prohibition.

According to the OFT web site, collusive behaviour involving more than 25% of the market is likely to be deemed “appreciable” but so too are *any* price fixing agreements since they can have a dramatic effect at a local level. Under the 1998 Act firms can be fined up to 10% of annual turnover for every year in which they engaged in practices which restrict, distort or prevent competition (to a maximum of three years).

Some examples of restrictive practices considered by the OFT include:

- Either overt or covert Price fixing
- Agreeing to deliberately reduce output to drive up the market price
- Making agreements to share markets e.g. collusive tendering
- The imposition of minimum resale prices

It is the duty of the Office of Fair Trading to monitor the activities of firms and to prosecute those thought to be acting as cartels. The OFT has wide ranging powers under the 1998 Act to enter business premises and search for incriminating evidence of collusion.

3. The Public Interest Criterion

The Competition Commission has to judge whether a proposed merger is in the public interest. They therefore have to consider both the likely costs and the likely benefits. The Fair Trading Act specifies the following issues to be considered when calculating the public interest. The Commission must ask about the impact of the proposed merger with regard to:

- “Maintaining and promoting competition in the UK
- Promoting the interests of consumers
- Promoting new products and reducing costs
- Maintaining and promoting the balanced distribution of industry and employment
- Maintaining and promoting competitive activity in overseas markets by companies in the UK” (www.competition-commission.uk/inquiries/role3.htm)

Clearly, there will be circumstances where the last two of these might conflict with the first three. The following table suggests in more detail some of the criteria that the Commission might use to inform this judgement:

Potential Costs of Mergers

Increased market power leading to lower output and higher prices, the possibility of price discrimination and the increased likelihood of collusive practices. Or, because of complacency, a lower quality of product.

In the absence of economies of scale any increase in prices will produce allocative inefficiency. Restrictions in output will be technically inefficient and may have adverse employment consequences.

Fewer firms may mean less variety of products available to consumers.
Reduced consumer choice.

The newly merged firm may be able to use its resulting market power to increase barriers to entry into the industry. For example, the risk of cross-subsidisation.

Potential Benefits of Mergers

Economies of scale. These might include the possibility of rationalisation, synergies, buying economies, economies of scope. However, these might also act as a future barrier to entry.

Market power inside the UK may be necessary to defend businesses from the threat of multinational companies. This may have beneficial employment consequences. Also, any redundancies may be merited if those workers can find more productive employment elsewhere.

The merger may allow greater expenditure on investment, and on research and development, and thus allow innovation and up to date products for consumers.

The EU Policy Framework

Within the European context competition policy is seen as being a necessary condition for the success of the single market. There are two articles of the Treaty of Rome relevant to competition policy which apply to firms operating across national borders:

Article 81 Covers restrictive practices, i.e. cartel like behaviour either in pricing or other forms of collusion. (This used to be article 85). Both horizontal and vertical restrictive practices are prohibited.

Article 82 Prohibits the abuse of a dominant position in the market, including those arising from mergers. Examples would include restricting output to drive up the price, and applying different conditions to equivalent transactions with different

suppliers or consumers. (This was formerly article 86). There are no market share or asset size criteria for investigation (which would be difficult given the trans-national nature of the activities of many firms) – rather, the behaviour of firms is examined to determine whether it is uncompetitive.

Current EU mergers policy is governed by regulation 4046 which came into force in 1990. The EU Commission will consider investigating any merger involving world wide sales greater than €5bn or where EU sales of at least two of the companies exceed €250 million. Note that any UK based merger eligible for consideration by the European Commission is examined by them, not the Competition Commission. The EU Commission has the power to ban activities contravening these articles and to impose fines on companies it judges to have been at fault to a maximum of 10% of worldwide turnover.

The developments in UK competition policy following the introduction of the 1998 Competition Act were to bring the UK broadly into line with EU policy. UK restrictive practices policy is now very close to article 81, the new powers for the OFT concerning firms which abuse a dominant market position coincide with article 82.

Evaluating The Policy Framework

When evaluating the UK policy framework some reference should be made to the theoretical debate with which this survey started. There are good a priori reasons for not having a blanket ban on mergers and for having a policy where each case is considered on its merits. Further issues to be considered might include:

- Only a very few of UK mergers qualifying for investigation are actually referred to the Competition Commission. For example, in 1997 there were 186 qualifying mergers of which only 10 were referred, yet of those investigated the vast majority are prohibited or conditions attached. So looks like too few referred. However, many mergers clearly have negligible effects on competition – it would create a distortion if all were investigated. Perhaps the OFT is just doing its job properly in filtering out mergers that should not be referred.
- The size of the relevant market determined by the OFT will often have a crucial bearing on the outcome of policy. The narrower the definition of market the more highly concentrated it is likely to be.
- Pragmatic basis of policy is probably best according to the theory of contestability which suggests that the market structure is not *in itself* a determinant of conduct by firms. That is, having a monopoly position does not *automatically* lead to an exploitation of that dominance. However, the concept of contestability can itself be critiqued.

- There are heavy fines for restrictive practices under the 1998 Competition Act. Some of these have started to bite e.g. However, secret collusion is difficult to identify – and tacit collusion almost impossible to tackle.
- Do we want competition internal to UK markets, or firms that have the economies of scale to stand up to the forces of world competition? Also, from an EU perspective in dealings with the rest of the world. However, perhaps it is the case that “Japanese and American firms are large because they have been successful, not successful because they are large” (Prof. John Kay).
- A pragmatic policy still needs to be conducted upon *transparent* and *consistent* principles. There have been large numbers of Secretaries of State for Trade and Industry, each with their own priorities. The consistency of the Competition Commission’s actual decisions also needs to be scrutinised.

A final judgment on many of these issues must rest on a detailed look at case studies. Whilst to do this fully would take us beyond the A2 requirements, a few indicators are included below.

Some Case Studies

Pupils should construct their own list of case studies. However, these do not have to be very detailed – the idea is to make concrete some of the theoretical ideas discussed above and get a feel for the variety of reasons put forward by the Commission as establishing the ‘public interest’. It would be useful for candidates to know summary details of one decision where the merger was prohibited, one where conditions were attached to the merger and another where the merger was allowed.

Case One: An Acquisition Allowed

In 2001 Kodak UK made a bid for ColourCare Ltd, a film processor. The initial fear was that Kodak, amongst other things a manufacturer of films with its own processing laboratories, would gain further powers of vertical integration as well as greater power in the film processing market. The Competition Commission concluded that the acquisition was not against the public interest for a number of reasons. First, the retail outlets where people take their films are mainly national chains with considerable monopsony power over processing suppliers – this would counteract any monopoly power Kodak gained from the merger. Second, that there is sufficient competition and consumer awareness in this industry not to be threatened by the merger. Third, that technological improvements might be brought about by the merger, particularly in digital processing. For further details see www.competition-commission.org.uk/reports/461kodak.htm

Case Two: Conditions Attached

In 1999 British Airways wanted to acquire CityFlyer Express, a BA *franchise* operating out of Gatwick. The Competition Commission found that this was likely to

be against the public interest because of the extra takeoff and landing slots that BA would obtain from the acquisition. However, the Commission found that the market for short-haul air travel was generally competitive enough not to have to prohibit the merger. Instead they placed a 41% restriction on the numbers of slots BA could command at Gatwick. Further details at <http://www.competition-commission.org.uk/reports/430ba.htm#summary>

Case Three: Merger Prohibited

In 1998, BSkyB attempted to merge with Manchester United football team. The Competition Commission felt that this would be against the public interest and recommended that the merger be prohibited. The Commission saw the merger as threatening to reduce competition in the market for live football games – with the likelihood that monopoly prices would begin to be charged for pay for view games. Competition would be reduced because potential new entrants would be unable to secure the rights to games and because BSkyB would have unfair market power in negotiations with the football league. For further details see <http://www.competition-commission.org.uk/reports/426sky.htm#summary>

***More General and Advanced Issues For Discussion**

Should there be a unitary competition authority in the UK rather than separate powers for the OFT, the CC and the Secretary of State?

Should the whole process be made politically independent (like the Monetary Policy Committee)?

Should the focus of legislation be the degree of competition rather than the ‘public interest’?

Are there no benefits whatsoever from cartel like behaviour by firms?

Has the 1998 Competition Act made a significant difference to the effectiveness of UK competition policy?

To what extent can the ‘public interest’ be determined in an EU context?

Should the ‘burden of proof’ be reversed? At the moment the Competition Commission or OFT have to establish anti-competitive practices. Should all mergers be blocked unless firms are able to prove the merits of their actions before proceeding?