COMPETITION ACT 2010: REVIEW OF MARKET BEHAVIOUR

SESSION 5: MARKET POWER AND DOMINANT POSITION

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Law and economics

- A law is an obligation (to comply) backed by sanctions (if/when someone fails to comply)
  - e.g. speed limit (law), speeding fines (sanctions)
- Legal approach (and thinking) is based on available facts, and also some intuition
- What has economics got to do with the law?

Law and economics

- Economists focus on the effect of a legal sanction on behaviour (similar to effect of price on demand)
  - Consumers respond to higher prices by buying less
  - Likewise, the heavier the sanctions, the lower will be the level of sanctioned activities (holding all other things constant)
- Economic approach to legal matters starts with a hypothesis, which is then "tested" (or "substantiated") on the basis of empirical data

An example

- Da-Same-B S/B signs a contract to deliver refined palm oil on a monthly basis from Malaysia to Margie P/L, a margarine manufacturer in Hong Kong
- In one particular month, a "plant disease" struck all of Da-Same-B's oil palm plantations
- With non-delivery of refined palm oil from Da-Same-B, Margie has to cease production in the following month
- Margie files a lawsuit against Da-Same-B and asks the court to award it an amount of "damages" equal to the revenues that Margie would have earned had the refined palm oil been delivered as promised

An example

- The court cannot resolve the dispute with reference to the terms of the existing contract
  - It is silent on the risk of “non-performance” in the specific event of a “plant disease”
- The court have to decide on whether Da-Same-B:
  - should be excused from meeting the contract on the grounds that the “plant disease” made it impossible to produce and deliver palm oil; or
  - it is in breach of the contract and should be ordered to compensate Margie for its lost revenues

Economic opinion

- Contract parties failed to allocate the risk of a contingency between themselves
- The loss that resulted from Da-Same-B's non-delivery should be:
  - assigned <u>efficiently</u> to establish the right incentives for proper contractual behaviour in future
  - assigned to the party that could have borne the risk at a <u>lower cost</u>

Economic opinion

- Da-Same-B is (arguably) better able to bear the risk of a "plant disease"
  - It is an agricultural business and can plan for alternative palm oil supplies – from its own inventory or sub-contracting with other local plantations
- Da-Same-B should therefore be liable for non-performance (breach of contract)
- Comment: In "real world" cases back in the late 60s, petroleum producers were found liable for non-performance (i.e. non-delivery of contracted supplies) due to the Middle East war

Competition law and economics

- "Competition law is about economics and economic behaviour"
  - Richard Whish, Professor of Law, King's College London and author of *Competition Law*, 6th edition, Oxford University Press, 2008

Competition law and economic regulation are not the same thing

Competition law	Economic regulation
Does not intervene in markets	Necessitated by on-going or impending ‘market failures’
Sustains and enhances the competitive process for the direct benefit of consumers (not firms or industries)	Involves direct intervention (minimum supply, or price ceiling; or both)
Deals with matters “after the fact” (*ex post*)	Usually involves *ex ante* (“before the fact”) rules

Market definition

- <u>Not</u> an exercise in identifying “real world” characteristics or features of a market (e.g. by referring to write-ups in business magazines, marketing materials or even industry reports)
- The purpose is to formalize, on a case-by-case basis, the context in which the effects of an alleged anticompetitive action are to be assessed

US Department of Justice (DoJ) and Federal Trade Commission (FTC)

- "A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm … that was the only present and future producer or seller of those products in that area likely would impose at least <u>a 'small but significant and non-transitory' increase in price</u>, assuming the terms of sale of all other products are held constant. <u>A relevant market is a group of products and a geographic area that is no bigger than necessary to satisfy this test</u>."
  - "Horizontal Merger Guidelines", revised 8 April 1997

Malaysian Communications and Multimedia Commission (SKMM)

- "Two goods or services will be treated as being in the same market if, and only if, they are substitutable for a purpose. Within the bounds of a market, substitution between goods and services occur in response to changing prices. It is these possibilities of substitution which prevent a firm from changing its prices without provoking a response from other suppliers in the market."
  - "Guideline on Substantial Lessening of Competition", RG/SLC/1/00(1), January 2000, para. 7.2(c)

Competition Commission of Singapore (CCS)

- "… the term 'market' has a specific meaning for competition law purposes. The essential task … is to define all the products on the demand side that buyers regard as reasonable substitutes for the product under investigation [the focal product] … and then to identify all the sellers who supply the focal and substitute products, or who could potentially supply them – this is the relevant market. This exercise … includes defining the geographical reach of the relevant market, which may extend beyond the area under investigation and in which the focal product is sold."
  - "CCS Guidelines on Market Definition", June 2007, para. 2.1

Australian Competition and Consumer Commission (ACCC)

- "A market is the <u>product and geographic space in which rivalry and competition take place</u> … (it is defined) by reference to products and regions <u>not by reference to the firms actually supplying those products or regions at the time</u> [of the case]. Substitution involves switching from one product to another in response to a change in the relative price, service or quality of two products (holding unchanged all other relevant factors, such as income, advertising or prices of third products). "
  - "Merger Guidelines", November 2008, para. 4.6 – 4.12

MyCC

- The term "market" has a special meaning in competition law … may <u>differ from how enterprises define a market for their own business purposes</u>
- … defining a market for competition law purposes is … about determining the level of competition and … <u>issues of market power</u>
- [it] … means <u>identifying all the close substitutes for the product under investigation</u>
  - MyCC *Guidelines on Market Definition* (2012 draft) http://www.mycc.gov.my/272_216_216/Web/WebPage/Guidelines-on-Market-Definition/Guidelines-on-Market-Definition.html

UK Office of Fair Trade (OFT)

- Market definition "… is not an end in itself but a key step in identifying the competitive constraints acting on a supplier of a given product or service … (it) provides a framework for competition analysis … (and) is usually the first step in the assessment of market power."
  - UK OFT, *Market Definition: Understanding Competition Law*, December 2004, p. 4

The steps taken

- Begin with the “focal” product, i.e. the product (or group of products) supplied by the firm that is under investigation
- Incrementally broaden the market boundary to include the next closest substitute(s)
  - This is done by applying a “hypothetical monopolist test” (HMT)
- Repeat the above until all close substitutes for the focal product are included
  - The relevant market is the one that includes the focal product and all of its close substitutes

Hypothetical monopoly test (HMT)

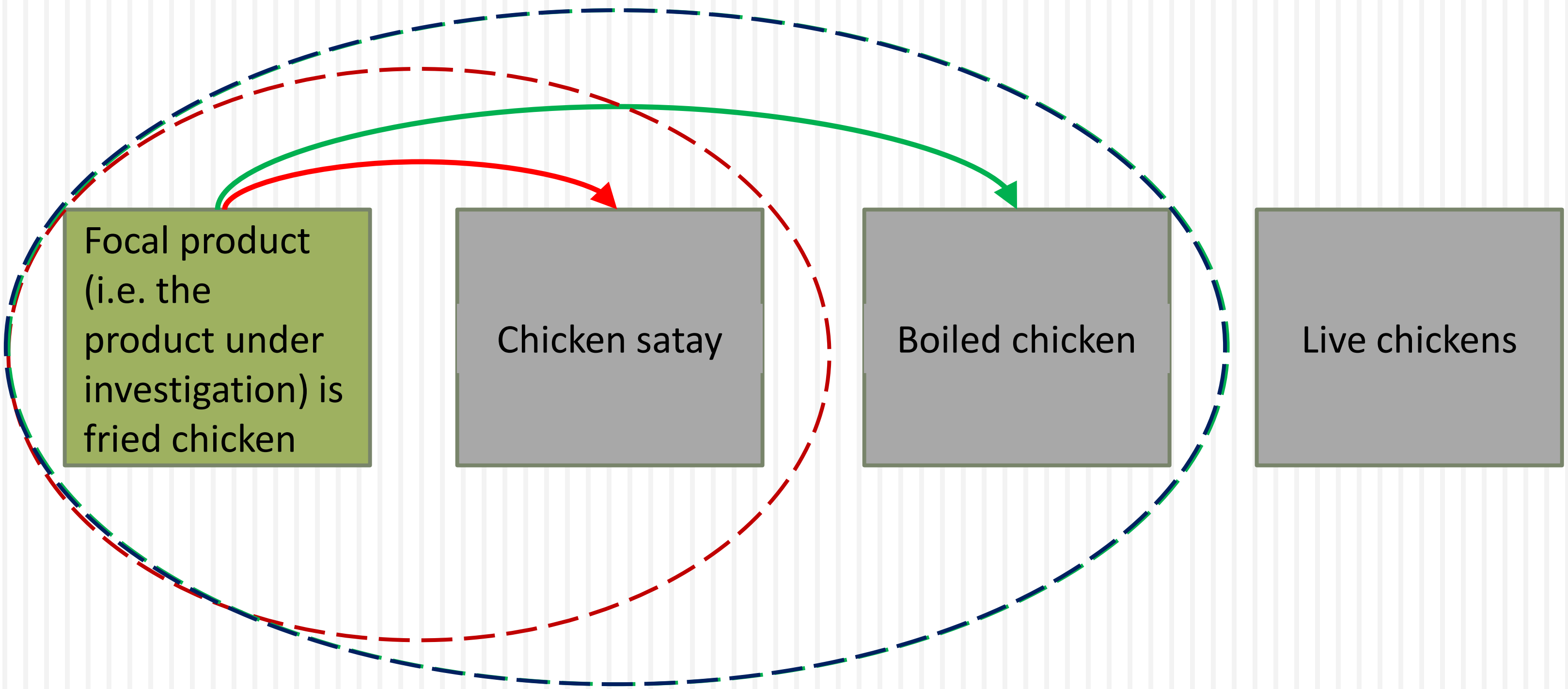
- Can a hypothetical monopolist sustain a "small but significant and non-transitory increase in price" (SSNIP)?
- SSNIP starts with the competitive price of the focal product (or service)
  - Competitive price IS NOT the prevailing market price
  - Competitive price IS reflective of an industry's economic costs of production

Hypothetical monopoly test (HMT)

- What's the hypothetical increase in the competitive price?
  - US DoJ applies a price increase of 5%
  - ACCC – at least 5%
  - EC, OFT & MyCC – anywhere between 5 to 10%
  - CCS – 10%
- Assess whether the price increase will be profitable to the hypothetical monopolist
  - If yes, the relevant market is none other than the market for the focal product
  - If no, "broaden" the market by including the next close substitute on the demand and/or supply-side
  - Continue with this market "broadening" until the hypothetical monopolist could sustain a SSNIP profitably

“Picture is worth a 1,000 words”

Consider the demand (and supply) response to a hypothetical 5 (or 10) per cent increase in price of fried chicken



Relevant market defined as market for cooked chicken

Other things to bear in mind

- Functionality (of the product) is incorporated into the analysis of demand (and supply-side) substitution
- Time dimension is incorporated into the analysis of competitive effects that can arise over a period of time (typically, 1 to 2 years)

Cellophane fallacy

- A phrase developed after the celebrated *du Pont* case (*United States v. E.I. du Pont de Nemours & Co.* 351 U.S. 377, 1956)
- The Supreme Court reasoned that if the existing price of Du Pont's cellophane was to be increased further, then users of cellophane will buy other packing materials (substitutes)
- It concluded that the prevailing price for Du Pont's cellophane was at its maximum level, beyond which the product will become substitutable – since any further price increase will be unprofitable, Du Pont had exhausted its market power
- But Du Pont's price at its maximum level was a monopoly price, not a competitive one
  - A different conclusion on the relevant market would have been reached if the Court had performed SSNIP using the competitive price as the starting point

Cellophane fallacy

- Two practical implications
  - Even if the prevailing price of a firm's product cannot be increased any further, it does not necessarily mean that the firm has totally exhausted its market power
  - Nowadays competition authorities are well-aware that using the firm's prevailing price as the starting point of a SNNIP will always lead to an overly narrow (and erroneous) definition of the relevant market

Supply-side substitution

- Some competition authorities prefer to define the market by focusing on demand-side substitution (e.g. OFT and, increasingly ACCC)
  - Supply-side substitution has more to do with market entry issues
  - How long does it take for a potential rival – who's either an existing supplier of another product or an entirely new firm – to enter the market?
  - Will their market entry require substantial investments?
- The supply-side constraints (on the hypothetical monopolist SSNIP) can be taken into account in a competition assessment of market power

Market power – introductory remarks

- Ability of a firm (or group of firms acting together) to raise price (or change other terms of sale) without losing an amount of sales that would make that action unprofitable
  - The demand for the product <u>must</u> be price inelastic
  - Thus, the own-price elasticity is an indicator of market power
- Bear in mind: Any business firm can be expected to seek, and even increase, its market power
  - It is a natural function of a commercially ambitious business
  - More on market power later

Market share

- Market shares of firms in the relevant market are calculated using historical data
  - May not reflect the ability of actual and potential competitors to increase production in the relevant market through expansion or entry
  - Question of how long a historical period, especially if the relevant market is one that involves large but infrequent transactions (e.g. orders for large pieces of industrial equipment)

Standard measures

- Sales volume (in quantities)
  - More appropriate if the products in the relevant market are relatively homogeneous
- Revenues
  - More appropriate for differentiated products
- Production capacity (which may include reserves)
  - More accurate than revenue-based measures because they incorporate supply substitutability and expansion, e.g. a firm with higher production capacity and/or inventory can respond quickly to a price increase by placing more product into the market

Any relationship between market share and market power?

- A high share of (relevant) market may be <u>correlated</u> with, but it <u>does not</u> imply, high market power
  - “The fact that market share of any enterprise is above or below any particular level [is not] ... conclusive as to whether the enterprise occupies, or does not occupy a dominant position …” *cf* s10(4)
- A firm with high market share may not be able to exercise its market power
  - Substitutes are available in the market
  - Rivals may have large excess production capacity
  - Key buyers may have strong countervailing power (more later …)

Market concentration

- A summary statistic that combines market shares of all (or some of the) firms in the relevant market
- CR4 (Concentration Ratio)
  - The sum of market shares of the four largest firms
  - The market is considered concentrated if CR4 > 75%
- Herfindahl-Hirschman Index (HHI)
  - Sum of the squared market shares held by all firms
  - This index takes into account the *distribution* of firm sizes
  - It increases as the number of firms decreases (from zero for perfect competition up to 10,000 for monopoly); it also increases as the inequality between firm size increases
  - The market is considered concentrated when HHI > 1800

A quick exercise

Market	MSIC 5-digit code	CR-4	HHI	Concentrated?
Caned pineapple	15131	99.9%	5,920	
Crude palm oil	15142	18.9%	163	
Refined palm oil	15143	43.0%	739	
Raw sugar	15420	99.3%	3,275	
Tea leaves	15493	86.0%	2,501	
Production of mineral water	15542	67.7%	1,658	
Tobacco product (manufacturing)	16000	93.5%	3,271	

Dominant position

- Defined by European Court of Justice (ECJ) as
  - “a position of economic strength enjoyed by an undertaking [i.e. a firm or group of firms] which enables it to <u>prevent effective competition being maintained on the relevant market</u> by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers.”
  - *United Brands v. Commission* (Case 27/76) [1978] E.C.R. 207, para. 65 (my emphasis underlined)

What’s “economic strength”, and how does a firm “behave independently”?

- No business firm can truly “behave independently”, especially of consumers
  - Consumer demand for a product is subject to a downward-sloping price-quantity relationship, *viz.* the higher the price charged by the firm, the lower will be the quantity demanded by consumers for its product
- All businesses have some degree of “economic strength” to increase price
  - But a (commercially sensible) firm will only do so if the revenues earned from a higher price are more than the revenues lost when consumers switchover to the same or similar products of other firms

Market power (revisited)

- Recall:
  - ECJ considers the purpose of abusing a dominant position is to “prevent effective competition from being maintained”
  - Competition is effective when no firm, either acting on its own or in concert with others, can exercise market power by restricting output and charging a higher price
- The “abuse of dominant position” is now recognised (and accepted by courts) as conceptually equivalent to an “abuse of market power”

Two forms of market power

- Power over price
  - The ability to raise price consistently and profitably above competitive levels
- Power to exclude
  - The ability to raise price (as above) or to prevent it from falling to competitive levels by excluding rivals from the market
    - e.g. by raising the prices of inputs used by rivals so as to "force" them to reduce their outputs

Sources of market power

- Barrier to entry / expansion
  - Barrier to entry = something that prevents or makes its difficult for anyone to enter the market
  - Barriers to expansion = something that prevents anyone (who is already in the market) from increasing output
  - Includes legal barriers, e.g. statutory monopoly, licensing, patents
- Sunk costs
  - Non-recoverable costs that must be incurred to compete in or to enter a market; e.g. large advertising campaigns, specialised HR training costs
  - In some cases, a firm will deliberately incur sunk costs as a strategy to raise entry barriers (e.g. advertising)
- Economies of scale (and/or scope)
- Product differentiation

Unilateral exercise of market power

- Concentration effect: not subject to market restraint by rivals (monopoly in extreme case)
  - If the differentiated products of two firms are close substitutes for one another, a merger may enable the parties to impose a unilateral price increase
- "Monopoly pricing" by firm in dominant position; firms in "competitive fringe" have tendency to also raise their prices
  - *Kimberley-Clark/Scott* case: EC concluded that downstream firms (retailers) have little incentive to resist any upstream price increase because it would enable them to earn more by selling label brands at higher prices

Coordinated exercise of market power

- Tacit collusion
  - Horizontal merger reduces the number of competitors
  - This makes it easier to monitor and detect “cheating” by other firms in the cartel
- Oligopolistic interaction (few rivals who “depend” on one another without formal collusion)
  - Mergers reduce the number of firms
  - Remaining firms are far more likely to recognise that they can gain by competing less vigorously
  - *Nestle/Perrier* case: EC concluded that the incentive and possibility to increase prices jointly was recognised by both companies, the proposed merger would facilitate and reinforce the likelihood of such a strategy

Bargaining power, monopsony power and countervailing power

- Bargaining power ≠ monopsony power
  - Bargaining power is the power to obtain concessions from a seller; it is achieved by <u>threatening</u> to impose a cost on, or withdraw a benefit to, the seller if the concessions are not granted
  - Monopsony power is exercised by buying a lower quantity of the product (at a lower price); the action is <u>actually</u> taken instead of being threatened
- Bargaining power = countervailing power
  - Can be exercised against the market power of suppliers (e.g. a supplier who charges a price above marginal cost)

Buyer power

- Buyer power = monopsony power + countervailing power
- If supply is competitive ("many suppliers"), a seller's profit-maximising price for its product is equal (or close) to marginal cost
  - Buyer can exercise monopsony power to lower the seller's price further
- If supply is not competitive (a monopoly or duopoly or "very few suppliers"), the seller's price will be higher than the competitive price
  - Buyer can exercise countervailing power (bargaining power) to obtain more favourable terms of supply

Examples of countervailing power

- A “large” buyer can threaten to switch from one supplier to another
- It can finance or sponsor the entry of new suppliers
- It can self-supply itself, e.g. a large retailer can buy from its own wholesale division, or a large wholesaler can buy from its own factories

Effects of buyer power

- Exercise of monopsony power against competitive suppliers – usually results in deadweight losses, even if the buyer faces intense competition in the output market
- Countervailing power against suppliers with market power – may benefit consumers and improve economic efficiency under some circumstances
  - Depends on the level of competition in the buyer's output market – the more intense the competition, the larger will be welfare benefits

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SESSION 7: MOCK CASE EXERCISE

29 March 2012

Mock case exercise

- 2/3 groups to be formed – attendees will be advised of their "group membership" before lunch break on 29 March 2012
  - Group A = plaintiff
  - Group B = defendant
  - Group C = Competition Authority (may not be necessary, depends on number of seminar attendees)
- The "facts" and briefing notes for the respective Group will be also be distributed at the same time
- The (tentative) schedule for the "mock case" to be held AFTER 3.30 pm tea break is as follows:
  - 3.45 – 4.15 pm: Discussion among each Group
  - 4.15 – 4.30 pm: Plaintiff's case
  - 4.30 – 4.45 pm: Defendant's case
  - 4.45 – 5.00 pm: Competition Authority's finding
  - 5.00 – 5.15 pm: Q&A

Mock case exercise

- The respective "brief" provided to each Group contains fictitious information and data that have been "manufactured" for the purpose of the mock case exercise
- Each Group's arguments should be limited to the information in their brief
  - Accept your mock situation as it is presented in the brief provided
  - You are allowed to make logical assumptions where you think the information in your brief is incomplete; or where some necessary information is missing

Thank you