

# CRA Competition Memo



## Why Fewer Firms will be Held Dominant in Future

Competition law is divided into three areas: the control of anti-competitive agreements between companies, the control of dominant companies, and the prevention of mergers which create or enhance dominant positions. One central economic concept provides a unifying link between them: namely, market power.

### The importance of power over price

Market power has a precise economic formulation. Its formal definition is the ability of a firm or firms to restrict output and thus raise price above the level that would prevail under competition and to make a profit from the action. Note that there are three parts to this definition. The first is that the firm or firms restrict output in order to raise price. This derives from the basic economic observation that, in all but exceptional circumstances, the demand curve facing a firm is downward-sloping: the higher the price the firm charges, the less sales it can be expected to make, *ceteris paribus*. The second part of the definition is the ability of the firm to increase price above the competitive level. The third, and perhaps the most neglected part, is that the action of increasing price must lead to increased profits. Any firm can choose to raise price at any time it wishes. But this does not necessarily mean that the firm has market power. Because demand curves slope down most price increases lead to loss of sales. Only if the losses of sales which follow the increase in price are small does the firm have power over price.

### The old approach

Economists have long criticised DGIV's assessment of dominance for its disregard of these principles. The Commission's attitude to Article 86 enforcement is heavily influenced by the precedent cases decided some twenty years ago - *United Brands*, *Hoffman La Roche*, and *Michelin*. Directorates B, C, and D of DGIV, following the Court, define dominance as "the ability to behave independently of customers, suppliers and competitors". While it is clear that this definition has something in common with the economists' definition of market power, it ignores the crucial idea: the increase in price must be profitable. Every firm is able to increase the price it charges for its goods or services. However, this increase in price will often not be profitable owing to the more-

than-proportionate decrease in sales. The omission of this crucial element from the Court's definition has the effect, *de facto*, of granting a great deal of discretion to enforcement officials - an obvious failing of the system.

### The new learning

The operation of the European Merger Regulation since September 1990 has given rise to a new and quite different approach to the issue of dominance. The new approach derives ultimately from the USA and in particular from the DoJ merger guidelines issued in 1982 and adopted in some form by various competition authorities around the world. In the US the economic concepts have been adopted by the courts in all areas of antitrust law, not just in merger control. This new approach has introduced an objectivity based on clear economic criteria. This economic approach has the added merit that objective criteria lead to quantitative benchmarks against which competing claims can be assessed using empirical evidence.

If we take seriously the idea that power to price above the competitive level is the critical concept then a large number of the decisions in classic Article 86 cases become obsolete, or at any rate misleading. The most glaring is *United Brands* where UBC (now Chiquita) had a market share of 40-45 per cent of bananas. On the basis of this market share UBC was found dominant. The decision brushed aside the fact of sharp price competition from major recent entrants. It is nearly inconceivable that in broadly similar circumstances a merger resulting in a market share of around 40 per cent would today be blocked on the grounds of single-firm dominance. A cursory reading of, *inter alia*, *Alcatel/Telettra*, *Varta/Bosch*, *Allied Signal/Norre Bemse*, *Kali/Salz* supports this view. There are some differences between abuse of dominance and merger control (see box) - but they do not account for the contrast between these cases and the older 86 cases.

### The dichotomy of approach

This difference in the application of economic principles has led to a dichotomy between the way the MTF on the one hand and Directorates B, C and D on the other approach the issue of dominance. Whereas the MTF places a systematic consideration of competition at the

heart of its assessment of dominance, other parts of DGIV use older more subjective criteria. This often leads to competitive assessments being made on the basis of markets defined with no reference to competitive forces at all. Instead, the assessment proceeds backwards: identify the practice you don't like, define the market as the area in which this practice takes place, find the firm dominant - and fine it.

For example, in the classic *Michelin Nederland* Article 86 decision Michelin was found dominant in the supply of tyres in the Netherlands. The Commission wanted to condemn Michelin's practice of granting discounts to retailers who attain certain sales thresholds. This was achieved by defining the relevant geographic market as the Netherlands where the alleged anti-competitive practice was taking place. In this member state Michelin had a high market share, which was taken as evidence of dominance. However, it is clear that, both then and now, tyres move across national borders to such an extent that Michelin had no power over price in the economic sense. The application of even the simplest quantitative tests directed at power over price - for example Elzinga-Hogarty and price correlation tests - would have revealed this error.

Nor is the dichotomy of approach confined merely to old precedent cases. In the *Boosey & Hawkes* case the Commission found a relevant product market in "UK-type brass-band instruments". This is an absurdity. If supply side substitutability means anything it must mean that makers of brass band instruments in America and on the continent of Europe must be in the relevant market because they need make only minor adjustments to compete. It is scarcely possible to believe that a merger of Boosey & Hawkes with a small instrument-maker would have been blocked.

Similarly, in *Sealink/B&I* Holyhead harbour was defined as the relevant market. The Commission, failing to focus on power over price, ignored a basic economic principle: that prices are determined at the margin. People travel through Holyhead as one stage of a journey from (say) London to (say) Dublin. Some of these passengers must use Holyhead but others need not. Because the port of Holyhead cannot price discriminate between different passengers, high prices aimed at gouging the captive customers would inevitably sacrifice the business of numerous marginal customers - i.e. customers who could choose another port. Now imagine a merger of Holyhead port with another port serving Ireland - (say) Fishguard. It seems to us highly unlikely that such a merger would be waived through the MTF on grounds that each market was unique and separate from the other. Occasionally the relevant market for abuse purposes is legitimately different

from that for merger purposes (see box) but this is unusual. In the usual circumstances (it would require empirical investigation to be sure) the Commission could not have it both ways: either there are enough marginal customers to link the two port-services markets into one (*ergo* no dominance at Holyhead) or there are not (*ergo* a merger of the two ports would be OK).

### Are mergers different?

There are at least two differences between single firm dominance in merger cases and in abuse cases.

**(i) The time factor**

Abuse of dominance is about behaviour in the past – it is inherently backward looking. Mergers review, by contrast, is about dominance in the (near) future – it is inherently forward looking. In principle this difference of time factor might matter where market conditions are changing rapidly in a predictable way.

**(ii) The benchmark of comparison**

An abuse-of-dominance inquiry asks the question, "Has Company X the power to raise price relative to the competitive level?" Merger control asks "Will the merged company be able to raise price relative to the current level?" It is possible that a proposed merger will not add to dominance even though Company X is dominant now.

These differences are occasionally of practical importance.

### Future prospects

The clash between the newer more economics-based merger standards and the older, arbitrary dominance standards cannot be ignored indefinitely. One will surely have to give way to the other. The victory will almost certainly go to the newer system for two reasons: the new standard is widely used internationally, and it is much more respectful of the true facts of markets. It is interesting to note that the new Form A/B provides an additional chapter modelled on the merger Form CO for the vetting of joint ventures under Article 85.

Moreover, a move towards objectivity in the area of abuse control will have the added benefit of reducing officials' discretion. At present too much of competition enforcement activity gives businessmen incentives to compete by satisfying regulators rather than satisfying customers. Fewer firms in future will be subject to pressure from ambitious over-zealous officials to run their business in less efficient ways. The future holds out the prospect that fewer companies will be held dominant. This prospect is to be wholly welcomed.

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