Week 4: Market Definition, Market Power & (Horizontal) Mergers

Frances Ruane (Frances.Ruane@esri.ie)
Department of Economics
Trinity College Dublin
Competition Framework

Industrial Policy
- Promoting growth strategically
  - State aids
    - Static/Dynamic
- Competition Policy
  - Dealing with anti-competitive behaviours
    - Deciding on Mergers
    - Promoting consumer awareness of competition
- Indirect Market Regulation
  - Impact of regulations on competition in Relevant Markets
Rhetoric regarding Competition

- Majority in favour – consumers, potential entrants BUT
- Strong stakeholder interests usually against
- Incumbent producers/distributors
- Employees / unions
- ‘Losers’ identifiable; ‘Winners’ – wider society
- Role of governments: who controls rhetoric?
Key issue for Competition Policy: is a market ‘Contestable’?

- No “harmful” inhibitions on entry and exit
- No “harmful” product differentiation
- No “harmful” coordination (e.g. price collusion)
- No “harmful” price discrimination
- No Excess (Economic) Profits
- Evidence of actual and potential competition
- If contestable, no role for intervention!
- Globalisation has increased contestability
Key Concern: Market Power

- Market Definition needed as baseline for measuring Market Power
- (PC – Monopoly) Spectrum

- Abuse of Market Power/Abuse of Dominance/Substantial Lessening of Competition (Anti-Competitive Agreements; State Aid)

- Theory: (P – MC) – limited use in application
Market Power & Merger Policy

- Policy is to protect/enhance Competition
  - Substantial Market Power Mitigates Against Competition as a Process
- Control of Mergers (Economics + Law + Politics) Vs Business appetite for Mergers
- Market Power and Own-Price Elasticity (Market Power and Cross-Price Elasticity)
  - Famous Cellophane Fallacy
- Indicators?
Market Power Indicators

- 1. Market Definition – product/geography
- 2. Market Concentration
- 3. Barriers to Entry
- 4. Competitive Environment (unilateral effects, co-ordinated effects, potential competition)
- 5. Efficiencies (merger context)
1. Market Definition

- How do we ‘define’ Market Definition?
  - *Not as obvious as it might appear.*

- Increased Prices and Reduced Demand:
  a. Demand Substitution (by consumers)
  b. Supply Substitution (by existing competitors) [included in EU but not US]
  c. Supply Substitution (by new competitors, i.e. new entry) [included in EU policy]
1. Market Definition

- Substitutes are crucial but
- What is the relevant price for looking at substitutes?
  - Abuse of Market Power/Abuse of Dominance – Use Competitive Prices
  - Merger - Current Prices unless a cartel
- Importance of Counterfactual Analysis
1. Market Definition - Product Characteristics Approach

- Product attributes, price differences and perceived customer views (surveys).

- Market is then “those products which are regarded as interchangeable or substitutable by the consumer, by reason of the products’ characteristics and their intended use.”
1. Market Definition – what does Market Power imply

- a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing it to behave to an appreciable extent independently of competitors and ultimately of consumers.

- Increasingly legal definitions are used
2. Market Concentration

- Concentration Increases as:
  (i) Number of Firms Decrease; and,
  (ii) “Inequality” in Market Shares Increase

- Proposed Concentration Measures:
  (i) Lorenz Curve/Gini Co-efficient
  (ii) Concentration Ratio
  (iii) Hirschman-Herfindahl Index (HHI)
2. Market Concentration

- Concentration Ratio
  \[ C_r = S_1 + S_2 + \ldots + S_r \quad (r = 4, 5, \ldots 8?) \]
  Common but not robust metric

- Hirschman-Herfindahl Index (HHI)
  \[ \text{HHI} = S_1^2 + \ldots + S_n^2 \]
  \[ 0 < \text{HHI} \leq 10,000 \]
2. Market Concentration

- HHI used as a Filter
- “Moderately Concentrated”
  1,000 < HHI < 1,800
- “Highly Concentrated”
  1,800 < HHI
- Part of the adjudication process – mergers
  not necessarily stopped if HHI > 1,800
3. Barriers to Entry

- Approaches
  A: Definitions
  B: Determinants of Market Structure
  C: Entry Deterrence in Practice

- Changes in approach over time:
  - 1968 US Merger Guidelines (Entry ignored)
  - 1982 US Merger Guidelines (Entry central)
3. Barriers to Entry: Definitions

- Bain (1956) “... factors that enable established firms to earn supra-competitive profits without threat of entry”: e.g., absolute cost advantage, product differentiation; scale economies

- Stigler (1967) “... costs that must be incurred by an entrant that were not incurred by established firms.”

- Natural, Strategic, Exogenous, Endogenous, ...

- Importance of First-Mover Advantage
3. Barriers to Entry: Determinants of Market Structure

- Economies of Scale
- Diseconomies of Scale
- Minimum Viable Scale (MVS)
- Minimum Efficient Scale (MES)
  - Size of MVS/MES relative to market size
- SCP Paradigm
3. Barriers to Entry: Examples?

- Learning Curve/Learning-By-Doing
- Better Technology
- Product Differentiation/Brand Loyalty
- Scale Economies/Fixed Costs
- Distributional Agreements/Restrictions
- “Imperfect” Capital Markets
- First-Mover Advantage
3: Barriers to Entry: Entry Deterrence in Practice

- Limit Pricing (Output) & Excess Capacity: Credibility and Commitment
- Raising Rivals’ Costs (e.g. vertical restraints?)
- Predation (reputation)
- Brand Proliferation
- Switching Costs (e.g. quantity discounts)
4. Competitive Environment?

- Unilateral Price Effects (≈ single firm dominance)
- Co-ordinated Price Effects (≈ collective dominance)

Market Shares: Symmetry, Stability
Homogeneity: Firm Structure, Firm Product
Transparency
Inelastic Market Demand
Absence (Non-Presence) of
  - Maverick Firms
  - Strong Buyers
  - Excess Capacity
5. Efficiencies in Merger Context

- Requirements of Merging Partners to demonstrate efficiencies:
  - Clear and Convincing Evidence
  - Efficiencies Specific to Merger – not just part of industry process
  - Corporate Control Market – ‘takeover’
  - Consumers Must Benefit (Consumer Surplus or Price Standard)
5. Efficiencies: Examples

- Corporate Control Market
- Economies of Scale/Plant Specialisation
- Better Integration of Production Facilities
- Lower Transportation (Distribution) Costs
- Variable Costs (recurring) v. Fixed Costs (once off)
- “Efficiency arguments are easy to make, but hard to evaluate.”