UK Competition Policy

This introduction to this subject was written for students studying economics and business studies at AS/A level but I hope it will also be helpful for others who are encountering this subject for the first time.

The competitiveness of British business is a key driver of **innovation**, **productivity** and the **efficient functioning** of the modern economy. These factors in turn drive improvements in GDP and the external trade balance.

Conventional economic theory shows that firms that enjoy market power can deliberately maximise their profits by raising prices and restricting production. But this result does not need to be deliberately planned. All businesses need to re-evaluate their prices from time to time, and their executives will naturally be more reluctant to raise their prices if they will as a result lose significant business to competitors. But if the company has significant **market power** (i.e. it has few competitors and no new competitors are likely to emerge) then it is likely to lose fewer customers following a price rise, and so more likely to profit from raising its prices.

A reduction in the number of competitors can have another pernicious effect as firms then fail to reduce their prices when they have the opportunity to do so, because they knows that such a reduction would quickly be matched by their competitors. No communication between firms is necessary, so this behaviour is known as **tacit collusion**, leading to prices which are 'sticky downwards'.

Competition Powers

Competition is such an important driver of economic performance that most countries in the world, including all countries in the European Union, have created competition authorities with strong legal powers aimed at preserving or increasing the extent of competition within their borders. These competition powers fall into five categories.

1. **Merger Control** aims to prevent firms gaining market power as a result of acquiring control of competitors. In the UK, **the Competition and Markets Authority** (CMA) reviews all significant mergers with a view to prohibiting those that are likely to result in a **substantial lessening of competition**. Smaller mergers are exempt from scrutiny – i.e. if the turnover of the firm being taken over is £70m or less *and* the combined firms will have no more than 25% market share. But mergers that create a company with a combined market share of more than 25% are very often allowed as long as the market remains competitive and/or it is relatively easy for new firms to enter the market.

2. It can be harder to counter the effects of market power if it arises otherwise than as a result of a merger. In the UK, however, the CMA has the ability to undertake **Market Investigations** of sectors in which there is evidence of inadequate competition. The CMA looks to see if it can identify an **adverse effect on competition** (AEC) arising out of identifiable features of the market. If so, the CMA has extensive powers to remedy the AEC by imposing behavioural conditions or forcing companies to sell part of their business. These very strong

powers are in practice used quite rarely, but they can be valuable where a market appears to be working very badly, or where privatisation has created a company with very strong market power. They were introduced after the Second World War in order to break up the cartels that had been a necessary feature of the wartime economy. Very few other countries therefore have anything similar.

- The CMA's predecessor authority investigated UK airports between 2007 and 2009 and required BAA plc (which owned many of the previously privatised airports) to dispose of Gatwick and Stansted Airports, thus increasing competition in the South-East of England, including for Heathrow, which BAA retained. BAA were also required to dispose of either Edinburgh or Glasgow Airport, this increasing airport competition in Central Scotland.
- As at early 2015, the CMA is investigating the UK energy and retail banking markets.

3. Most countries, including the UK, have **Economic Regulators** which act as a substitute for competition where companies have **substantial market power**, most obviously where there is **a natural monopoly**, for instance in **the utility industries** where companies often have a natural monopoly in supplying energy, water etc. via wires and pipes which are expensive to duplicate. These companies may only operate if licensed to do so by the regulator, which will impose strict limits on the extent to which the company may raise prices or reduce the quality and range of its products, or the quality of its customer service.

The use of the above three powers does not imply the existence of any misbehaviour. All companies will deploy market power to their own advantage if they are able to do so. In contrast the other two powers, listed below, are aimed at punishing companies that are behaving very badly, either individually or collectively. If the allegations are proved then very large fines can be imposed or, in the worst cases, executives sent to prison.

4. Companies are guilty of **abuse of dominant position** if the CMA can show (a) that they are dominant in their market, and (b) that they have taken steps to eliminate the limited competition that remains by unfair means, such as:

- **Price discrimination** - offering price reductions and volume discounts to those customers who may be tempted to leave you for a competitor.
- **Tying** - such as tying one product to the sale of another, being restrictive of consumer choice and depriving competitors of outlets.
- **Refusal to supply a facility that is essential for all businesses attempting to compete -** The most obvious essential facilities are in the transport industry: docks, bus stations & airports.
- **Predation** (as in preying on a victim). This behaviour includes predatory pricing - the practice of dropping prices of a product so much that smaller competitors cannot cover their costs and fall out of business - and other predatory behaviour - e.g. running new bus services at frequent intervals so as to force a new competitor out of the market.

None of the above behaviours are objectionable, of course, if they are carried out by non-dominant companies that are aggressively competing to retain customers. In practice, therefore, competition authorities have to carry out complex economic analyses in order to prove that the beneficial consequences of the behaviour (such as price cuts) are outweighed by the negative consequences (the elimination of competition). Successful investigations are relatively rare, but here are some examples:

- The European Commission fined Microsoft €497 million for including its Windows Media Player within the Microsoft Windows platform.
- As at early 2015, the European Commission is investigating Google for abusing its dominant position in the internet search market.

5. Finally, it is illegal to enter into **agreements which prevent, restrict or distort competition**, unless specifically permitted by the competition authorities. Franchise and similar agreements are therefore often OK, but other agreements not to compete are usually prohibited. Price fixing agreements (**cartels**) are particularly deprecated, especially when they are secret, and executives who enter into such agreements are guilty of a criminal offence and can be jailed. The CMA offers very lenient treatment to the first member of a cartel which comes forward to 'blow the whistle' on the arrangement. This has proved very effective in busting several secret cartels, and no doubt deters the creation of many more.

- As at early 2015, the American authorities are seeking to force Apple to pay compensation of $400m to 23 million customers for conspiring with publishers to raise e-book prices and thwart the growth of Amazon's Kindle offering.
- Secret US Justice Department filming of members of the international Lysine Cartel may be found on YouTube.

<u>Discussion</u>

Competition authorities are generally reluctant to intervene in a market unless it is clear that there is a major problem which will not be corrected, within a reasonable time, as a result of competition from new entrants to the market and/or innovation and new technologies. Microsoft, for instance, was once the target of sustained attack by US competition authorities, but its behaviour was eventually constrained as a result of growing competition from Apple and others.

It can be quite hard to decide whether a company has (or merging companies will have) sufficient market power to justify the prohibition of a merger, or a finding that a company has a dominant position. One helpful approach is **the hypothetical monopolist test** which seeks to identify the smallest range of goods or services within which a hypothetical monopolist could impose a profitable significant increase in price. Having identified such a market, the

authority can then decide whether the company's share of that market is high enough to cause concern. By way of example, the market for iron ore could certainly be monopolised, for there are no close substitutes. So the CMA would be very unlikely to permit a merger which created a company which controlled, say 75% of that market. But it would be hard to monopolise the market for, say, English eating apples because customers would probably respond to a price rise by switching to other apples or other fruit. A merger in that sector would therefore be more likely to be allowed.

Although much economic analysis focuses on the price effects of ineffective competition, it is important to note that evidence of inefficient competition can also or instead emerge in the form of lower quality, a reduced range of goods and services, and/or poorer service. Competition analysts accordingly look at the **price, quality, range, service** combination (PQRS) rather than focussing on price alone. Also, inefficient competition does not necessarily lead to high profits. Firms that have little to fear from competition are often inefficient, so their higher prices are eaten into by their high cost base, often including higher wages.

Competition Authorities

Competition policy throughout the European Union is the responsibility of the European Commission. The principal legislation is contained in **Articles 101 and 102 of the Treaty on the Functioning of the EU, the EU Merger Regulation** and various directives dealing with the regulation of individual industries. Investigations which have a significant international element are carried out by the Commission.

Individual member states are all required to have very similar legislation so that they can carry out similar investigations into their domestic cases. Within the UK, competition policy is the responsibility of the Secretary of State for Business Innovation and Skills. The principal legislation is in various **Competition and Enterprise Acts**. The main competition authority is **the CMA**, whose decisions can all be appealed to a specialist court, **the Competition Appeal Tribunal**. The main economic regulators are the Ofcom (communications), Ofgem (energy), ORR (railways) and Ofwat (water).

Further detailed information can be found on the CMA's and Regulators' websites and at www.regulation.org.uk.

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