Competitive Effects Module Transcript

Slide 1

Amelia Fletcher: Hi. I am Amelia Fletcher, Chief Economist at the UK Office of Fair Trading. In this ICN Curriculum module we are going to be learning about "Competitive Effects".

Slide 2

Amelia Fletcher: You'll hear from me, and my colleague Andy Gavil, Professor of Law at Howard University on the law and economics of competitive effects, as well as the elements of an effects-based approach to competition policy and enforcement.

To keep things interesting, but also practical, we'll be making use of a hypothetical case study to illustrate some of the principles that we will be covering. You'll also hear from several competition agencies from around the world on how they applied an effects-based approach to actual cases.

Slide 3

Amelia Fletcher: After this module we hope that you will have a better understanding of:

1. What is an effects-based approach to competition policy and enforcement?

2. What are "competitive effects" (both pro and anti-competitive), and how might they arise?

3. What are the important economic questions that a competition agency should be looking to answer in applying an effects-based approach?

This module is not meant to cover the different tools for evaluating competitive effects in particular cases, which are as numerous and varied as the cases themselves. Nor is it specifically targeted at specific types of conduct. In particular, we wont be providing a detailed guide to the economic assessment of predation, let's say. At the same time we are including within our remit, the competitive effects of some behavior that might in some jurisdictions (many jurisdictions maybe) be termed *per se* illegal (not requiring proof of effects for illegality).

As such , this module it is designed to provide an introductory overview to the competitive effects framework.

Slide 4

Amelia Fletcher: To start, let's begin with the aims of competition policy.

In a competitive market, firms do best when they offer consumers the products and services they most want at the lowest possible prices. So it is this competitive process that leads to the most beneficial market outcomes.

The overarching aim of competition policy is therefore to protect this process of competition – albeit not necessarily individual competitors, but the process of competition. And that's to the benefit of consumers and efficiency.

Those benefits can include lower prices, but they can also include better quality or service, greater range (of products) or even more innovation in new products.

That said, more competition is not always better. Increased efficiencies, like cost savings for example, can counterbalance restrictions of competition.

Therefore in bringing any case under competition law – as a matter of economics – it is important always to consider the theory of harm, or what is expected from this behaviour in terms of competitive effects.

Slide 5

Amelia Fletcher: The overarching aim of competition policy does not in fact depend on statute or form of agreement or conduct. Moreover, the anticompetitive effects can have very strong similarities across different forms of agreement, conduct and statute.

But under an effects-based approach, the nature of the competitive effects typically matters more for the analysis then the traditional legal categorization.

Economic analysis enables us to assess whether the conduct is anticompetitive. And that may well also include analysis of the intent of the parties involved, and their ability to restrict competition. But overall, the focus is on the conduct that enhances market power or restricts competition.

Slide 6

Amelia Fletcher: Now, there are two anticompetitive paths to market power. The first is direct, this is where there is a direct limiting of collective output or a direct increasing in price. Examples include where firms collude with their rivals, or actually mergers falls under that heading as well, horizontal mergers.

The other is more indirect. This is where you limit your rivals output, or in other ways disadvantage your rivals. This in turn makes them less effective competitors, or may even exclude them from the market entirely, and that generates market power for the parties that are limiting the output.

The crucial economic question that we're asking in each case though is "Will the conduct under examination - directly or indirectly - create, enhance, or facilitate the exercise of market power.

Slide 7

Amelia Fletcher: Now, in assessing these, there are a number of key factors that need to be analysed alongside the behaviour.

First, closeness of competition. Are the colluding rivals, or the rivals that are having their output limited particularly close competitors.

Ease of entry. Barriers to entry can take many forms. For example: sunk costs, regulations, customer loyalty, proprietary intellectual property, economies of scale, etc. Easy entry can be really important in limiting market power – limiting the ability of parties to gain or exploit their market power. Barriers to entry enhance market power.

Buyer power, also, can play a key role in reducing the likelihood of anticompetitive effects arising.

And efficiencies can counterbalance anticompetitive effects.

Slide 8

Amelia Fletcher: Now, let's introduce a hypothetical case to see how competitive effects analysis might arise in practice. The case involves three hypothetical companies in the LCD TV market: Richmond, Stanmore and Nash. Richmond, is the largest firm in the market , but it's been losing share to Nash, a recent entrant who has been competing aggressively on price. Richmond is thinking about how it might respond. This next scene features a meeting between the CEO and Vice President of Marketing…

Slide 9

Vice President: So you wanted to see me about something?

CEO: Yeah, I was briefed at an extended board meeting today, that our sales are sharply down this quarter – can you tell me what's going on?

Vice President: Yeah, here is the current state of play, those are the year-on-year sales figures. The marketing campaigns that we've introduced this past quarter haven't been working as well as we thought. Nash has been aggressively undercutting our prices, as you know, and as a result they are stealing market share and shelf space.

CEO: Well, what it seems like to me is that Nash is free-riding off our distribution network – we've invested a lot of money in that network, we are continuing to invest money, and all we are doing really is financing Nash's entry.

Vice President: Right, it was certainly a lot easier before Nash entered the market. What we're hearing from our major retailers is that they are increasingly reluctant to stock our products because they want to leave room on the shelves for Nash. But we are still by far the market leader with about 60% share.

CEO: Well, not for long if Nash keeps on growing.

Vice President: Right, we need to do something about that. So one idea might be to introduce a loyalty scheme for our major retail partners - that would give them the financial incentive to stock our products and not Nash's.

CEO: So, how would that help us? We've always relied on marketing the quality of our product before. How would that work?

Vice President: Well, the way it would work is that we would give our retailers a sufficiently large rebate if they meet certain sales targets, say last year's sales. That would give them the incentive to sell our products instead of Nash's, and would give us back our shelf space.

CEO: Right, I see how that works. Retailers will be willing to invest in our brand if the lump-sum is high enough. But what about Stanmore's distribution network? I assume Nash will still have access to that? What to stop consumers just buying [Nash] TVs from one of [Stanmore]'s major retail partners?

Vice President: It's not perfect, but we are still by far the market leader with about 60% share. So I think if we cut off enough of Nash's distribution network it might be enough to halt their growth and push them to more costly or less convenient modes of distribution. And then we might be able to get prices back to a more comfortable level, at least enough to justify the rebates.

CEO: Alright, well it could certainly work if Stanmore implemented a similar scheme. They've got around 30% market share – so together we have around 90%. I'll speak to the Stanmore's CEO; they're in a similar position and might be willing to start a similar scheme.

Vice President: Yeah, that's a really great idea actually., in fact you'll probably be seeing their CEO at that trade conference that you're going to in a few weeks. So you might mention it to him there.

CEO: Good idea. So, could you have a think about the numbers first? How the scheme would work in practice?

Vice President: Yeah, I'll have a think on it. I 'll send you an email later today.

CEO: Thanks

(Voice-over as scene shows VP typing) "Thanks again for meeting with me today, I thought that was a really productive meeting. We really need to do something about this Nash situation. Following up on your suggestion, I've crunched some numbers to see if a loyalty rebate scheme would actually make sense for us. I am attaching to this e-mail my initial projections. They show that it would be profitable for us to introduce a 10% rebate as long as retailers match last year's sales. We could increase the rebate to 15% for those retailers that have stocked more of Nash's product lines in the past few months - I think those retailers will need more convincing in order to exclude Nash from the shelves. To avoid taking a profit hit we would need to increase wholesale prices if we go ahead with this. I do think that retailers will be on board, especially if we manage to get Stanmore involved as well. You can consider mentioning this to Stanmore's CEO when you meet with him, but I suggest that we get these rebate schemes in place straight away."

Slide 10

Amelia Fletcher: As we just saw, the CEO of Richmond is very concerned about losing share to Nash. The marketing Vice President has suggested a solution in the form of a loyalty rebate scheme, in an effort to exclude Nash from the shelves. The CEO has also suggested that the second major supplier, Stanmore, might be persuaded to adopt a similar strategy to exclude Nash from their competing retail network. The Vice President has crunched the numbers and has e-mailed the CEO the projections, which one might expect to provide useful evidence for a competition authority. But first, let's see if the CEO of Richmond is able to convince the CEO of Stanmore that this would be a good idea.

Slide 11

Richmond CEO: Hi

Stanmore CEO: Hi, how are you?

Richmond CEO: I'm very well, how are you

Stanmore CEO: Good thanks.

Richmond CEO: Good, good. There's something I wanted to discuss with you.

Stanmore CEO: Yeah, is it about your loyalty scheme, I hear you're giving generous lump-sum payments to retailers for meeting sales targets.

Richmond CEO: Yeah, well we had to do. I mean you know how difficult it's been this year, and I'm sure you've seen your own sales figures go down this quarter

Stanmore CEO: Yep, significantly down because of Nash. New firms like Nash are going to destroy this industry.

Richmond CEO: Well they are, they are completely undermining out retail network, margins are being squeezed and it's only a matter of time before others come into the market.

Stanmore CEO: Tough times, but what can we do?

Richmond CEO: Well, what we're hoping is that with this rebate scheme, retailers wont have the space to stock Nash products. There's certainly a strong financial incentive.

Stanmore CEO: But, can't they just use my distribution network.

Richmond CEO: Well you could do exactly the same.

Stanmore CEO: But how would that work? It would take a lot of time and a lot of money to invest in that sort of capability.

Richmond CEO: Well how about I send you a copy of our retailer contract, you can use that as a template. That should help speed up the process. But please do make sure you keep this all confidential.

Stanmore CEO: Yeah, but what about the cost, it's going to hurt in the short term.

Richmond CEO: Well, actually if we put up wholesale prices then we can make back the rebates as we go along. And if we both do it, then retailers can put up their own prices thereby maintaining their margins.

Stanmore CEO: I see what you're saying; this might be a way to get our sales back up. What's your timing?

Richmond CEO: Well we're ready to implement the rebate scheme straight away, and we think we can put up a price increase in about 4 weeks time.

Stanmore CEO: Ok, I'll look into it.

Richmond CEO: Great!

Slide 12

Amelia Fletcher: So, Stanmore and Richmond have appeared to reach an agreement in principle here. Stanmore's CEO has agreed to send a template of it's retailer rebate contract to Richmond's CEO. Hmm, one might expect that sort of correspondence to be valuable evidence for a competition authority.

Note that the effect of the scheme will not simply be to harm and exclude Nash, but also (and importantly) to harm consumers by restricting choice and increasing prices. Now, let's see how a group of consumers react once the scheme has been implemented.

Slide 13

Consumer 1: It's really strange, last weekend I went shopping for a new LCD TV but prices seem to be going up everywhere.

Consumer 2: That's interesting, because I went shopping three days ago and I went to lots of different stores and Richmond and Stanmore's products were just so much more expensive than I expected

Consumer 3: I wanted to get a Nash TV, it's got some nice features on it, and it's a little bit cheaper, but none of the major retailers seem to be stocking it. One sales assistant told me that they needed the space for other products. I mean, I can still buy from Nash online, but I actually really value seeing the TV in the store, and also, with the online delivery risk it's just not really worth it.

Consumer 2: Hmm. Did you try calling around because I'm sure they must stock Nash TV's somewhere?

Consumer 3: Yeah, but none of the convenient ones seem to have it, and I really don't want to drive all the way across town as well.

Consumer 1: Yeah, it's really weird because I thought Nash was selling really well and expanding.

Slide 14

Amelia Fletcher: So, it appears that the scheme has been successful, from the point of view of Richmond and Stanmore. Nash is no longer on the shelves of the major retailers, and this has apparently resulted in consumer harm from increased prices and less choice - probably higher profits also for Richmond and Stanmore.

Note that while customers can still access Nash online and through less-convenient retailers, these are not considered viable options for customers, for a variety of reasons (things like search costs, higher risks, etc.). Nash has therefore been foreclosed from a key distributional channel.

Now it's often competitors that alert competition authorities to anticompetitive behaviour, but actually consumers can also pro-actively make complaints as we will see in the next action scene. Some jurisdictions even make use of customer surveys, in appropriate circumstances, to gather pertinent information - albeit, sometimes this is not practical.

In the next action scene we'll see what happens when some of these consumers, and Nash, voice their complaints to the competition authority.

But before that, let me turn it over to Andy Gavil.

Slide 15

Prof. Andrew Gavil: In our opening scenes, we developed our hypothetical to help us examine the economic analysis of anticompetitive effects. In our hypothetic industry, we have three principal players, Firm X, Firm Y, and Firm Z. Firm X has a 60 percent share of the market, Firm Y 30 percent, and Firm Z, our new entrant, has entered and has garnered a share of 10percent. The question we now examine is, how can X respond to this new entry by Z.

Slide 16

Prof. Andrew Gavil: Well, first it could respond by more aggressively competing. It could improve its product, it could lower its price. It could look at its costs of manufacture and distribution and try to compete head to head with Z. It could also think about colluding with Y and Z, forming a cartel to raise price, inviting Y and Z to join it to stabilize pricess. It's ultimate option is to try to exclude Z. It can either do that by itself, if it's capable, or it can actually collude with Y to exclude Z.

Slide 17

Prof. Andrew Gavil: We're going to examine these two possible anticompetitive ways to achieve what we call in antitrust "market power," and there's a separate module on market power that you might want to consult before going forward on this one. Market power in an anticompetitive sense can be established through collusion – that's the scenario in which X colludes with Y and Z to raise price, and what they would do is collectively restrict their output. But X can also achieve the same result – the ability to exercise market power -- perhaps by impairing or completely excluding Z from the market. In that sense, it's restricting Z's output which might achieve the same result, market power, as we see in this slide.

Market power is at the core of our concern about competitive effects. Market power as defined, is the ability to raise price above the competitive level. But it can also be a way to restrict other components of competition, like quality, or innovation. As we move forward and think about the two ways we've discussed to establish

competitive results, collusion and exclusion, we can move to the next slide, and see a visualization of the contrast between the two.

Slide 18

Prof. Andrew Gavil: With collusive competitive effects, we have direct impact on the next level of buyer, that could be consumers, or in our hypothetical, it's the retailers. And what we notice is that the firms, here depicted as firms A, B, and C, can collectively reduce output and raise price or restrict some other dimension of competition. Typical examples would be price fixing, but it would also be true of a horizontal merger among the three. The point here is that the economic analysis would be the same regardless of the form of the behavior. If you had rivals collectively restricting output, they might be able to exercise market power, collectively, by restricting output, or raising price. But there's another alternative, a different kind of competitive effect, an anticompetitive effect that we associate with foreclosure, or exclusion, and that's depicted in the next slide.

Slide 19

Prof. Andrew Gavil: Here we have Firm A, trying to impair or impede Firm B. How can it do that? Well, it might do that through input foreclosure, perhaps through an exclusive dealing arrangement with its suppliers that would either raise the price or completely cut off B from access to needed supplies. For example, in our hypothetical, that might be an important component of flat screen televisions, perhaps the screen or some other component that B does not make, but which it purchases from input suppliers. X might also be able to impair Z's ability to compete, to raise its costs or to completely exclude it from the market by entering into exclusive dealing agreement with dealers, so that dealers might refuse to deal with Z, or they might deal with ZB on terms less favorable than they are willing to deal with X. The end result of either collusion or exclusion would be the same. They would both result in higher prices or some other restrictive dimension of competition.

Slide 20

Prof. Andrew Gavil: Let's compare collusive and exclusionary anticompetitive effects and think a little bit further about how it would change our ability to analyze the conduct. They're both anticompetitive, but with collusion, the goal, if you will, is to marry your competitors. Collusion is always characterized by some direct relationship with rivals that allows them collectively to restrict output and raise price. With exclusion, instead of joining with competitors, the goal is to eliminate or impair a competitor. Sometimes collusion is called classical market power, whereas exclusion can be referred to as exclusionary market power. Now exclusion may involve a single firm, or as we have created in our hypothetical, joint conduct by X and Y. Sometimes it's referred to as involuntary cartel, if the two rivals succeed in

coercing Z into raising its price by squeezing it at either the supply or the dealer end of the transaction.

There are some key properties that are important to keep in mind with both collusion and exclusion. Both harm consumers and efficiency. Both are ways to exercise market power. Each can occur separately or together, so that firms might be engaged both in collusion and exclusion at the same time, as we'll see is going to happen in our hypothetical. Each can reinforce the other, so that exclusion can actually make collusion work better. For example, if X and Y alone try to raise price, they might not be able to do so successfully. Z would happily take away their customers at lower prices. So, in order to perfect their collusion, X and Y might actually need to somehow impair Z, or raise its costs, to keep it from interfering with their collusion.

The important point is that the economic analysis of the immediate consequences can vary. With collusion, you focus on the immediate economic consequence downstream. With a cartel, we look at retailers and dealers and consumers, and see what the impact is. With exclusion the analysis of effects is sort of two steps. First we look at the impact on the rival, and second, the ultimate impact on consumers and retailers. Again, the end result could be the same.

Let's now look at what X and Y seem to be proposing. They seem to want to collude together, but the goal of the collusion is to exclude Z, as we'll see in the next slide.

Slide 21

Prof. Andrew Gavil: There are some important issues that the agency will want to explore. Will X and Y acting in concert be able to succeed in raising Z's costs? If they can, will that increase in cost be sufficient to facilitate power over price for X and Y? Will it keep Z from being an effective competitor? And finally, will the conduct also produce any efficiencies? You cannot look just at the anticompetitive effects in evaluating the overall context of the conduct and effect. You've also got to consider efficiency justifications.

Slide 22

Prof. Andrew Gavil: So what will the focus of the agency's investigation be? They will look at market structure, including conditions of entry, to make sure they understand how this market functions. What are the conditions that either facilitate or impede competition generally? They are also going to want to have a detailed understanding of the discount policies that have been proposed. What are the likely effects of those discount policies, not only on X and Y, but on Z, and if implemented, what are the actual effects of the proposed policy? If it has not yet been implemented, the agency will have to make some predictions about probable effects. And finally, they are going to also need to consider justifications.

Notice that in our problem we have both collusive effects and potential exclusionary effects. So the agency will want to look at both the immediate impact of the conduct of X and Y, but also the potential additional exclusionary effect of the conduct directed at Z.

Slide 23

Kate: So are there any other possible cases that have come to light this week?

Zoe: Well, we've had a high number of consumer complaints in the LCD TV market. Complaints in the last three months have actually tripled and people seemed to be concerned about higher prices and less choice.

Jib: Yeah, I got a phone call yesterday from a company called Nash. They are a new entrant in the market for the production and distribution of LCD TVs. They complained about the market situation and they want to meet with us.

Kate: Alright, so who are the main players in the market?

Zoe: Well the market for LCD TVs has been growing relatively quickly, but market shares have been quite stable. There is a company called Richmond, which is a dominant player and they have about 60% market share, and then Stanmore with about 30% (share). Nash entered the market last year and they have been growing quite quickly. They say they have a market share of about 10% now. And their product does have some better features and it also support open standards, which makes it more versatile.

Jib: Yeah, and Nash has actually just recently built a new plant which has made their production more efficient and this has significantly reduced their cost of production relative to Richmond and Stanmore. And it also seems that the main distribution channel in this market is via retailers. This is because customers consider this product to be expensive and they want to see the TV "live" before buying. And also, they value customer service.

Kate: So what's happening now, what's the issue?

Jib: Well, the issue is that Nash is concerned that there has been an agreement between Richmond and Stanmore to set up a loyalty rebate scheme for retailers. And as a result, retailers are no longer stocking Nash products because they want to get the loyalty bonus and (therefore) stocking Nash products could be risky. Nash indicates that there has been significant and immediate fall in retail orders, of 60%.

Kate: So what do we think is the effect on consumers, is there a realistic theory of harm.

Zoe: Well there could be, if Richmond and Stanmore are working together, because if Nash is excluded and then subsequently they are able to raise wholesale prices. And then, retailers will pass that price increases through to consumers. In fact we have already had some consumer complaints already suggesting that retail prices have gone up.

Kate: I see. But could there be other reasons for Richmond's behaviour? Is it possible that consumers could benefit from the scheme in some way?

Zoe: It's possible that there could be economies of scale for Richmond and Stanmore. And retailers -- it's possible that retailers could see some cost savings for dealing with one fewer supplier. So some of those cost savings could be passed through to consumers.

Jib: It also seems that that there are some retailers in this market, that Richmond and Stanmore are using, who seem to have a lot of expertise in their products. This suggests that they may have invested a lot in their retail distribution network, and they may be concerned that Nash is free-riding.

Kate: Ok. Well, I think it seems sensible to gather some more information on this, to test the theory of harm. Jib, can you gather some market intelligence: market shares, prices, anything you can get your hands on really. I want to get a better picture for what's really been happening in the market. It would also be good if you could see how this case fits in with the economic literature on loyalty discounts - there must be some stuff out there. Zoe, can you speak to the retailers and set-up a meeting with Nash?

Zoe: Ok. Should we also try to get a warrant?

Kate: Good idea, if the (loyalty) agreements were introduced around the same time they might well have been talking to each other.

Slide 24

Amelia Fletcher: For purposes of this case, we are putting aside market definition. There may very well be other substitutes for LCD TVs, and this inquiry should of course be made. For a comprehensive discussion on market definition you may wish to access the curriculum module on market definition.

Notice how the competition authority is focused on the "theory of harm" here and the "effect on consumers" rather than the impact on Nash. So that's a reminder that competition policy is not about protecting competitors, but about protecting competition.

Note also that the authority is keeping the theory of harm in mind when thinking about what evidence to gather, and is ensuring that the theory is consistent with economic literature.

Finally, see how the competition authority is keeping an open mind as to potential beneficial aspects of the alleged conduct (so efficiencies) at this stage (we will revisit this later), but first let's see what happens after the Competition agency gathers some evidence.

Slide 25

Kate: So guys, I thought it would be useful to have a follow-up session on our meeting we had a couple of weeks ago when you both went off to get some information. So, could we run through what you have found out, please?

Jib: Yes, we have actually completed the (preliminary) assessment and it seems that we were right. We found that Richmond and Stanmore use largely separate retail distribution networks. And also they have (collectively) pretty much s full coverage of the bricks and mortar retailers, and this is the main distribution channel for these products.

Zoe: In terms of the rebates, it seems that Richmond put a loyalty rebate scheme in place about 4 months ago, and then Stanmore subsequently followed about a month later, and it appears that most retailers are participating in this scheme.

Jib: And we also found that the prices of Richmond and Stanmore have increased by similar amounts. We didn't find any evidence as yet to indicate that the increase in their prices is supported by some increase in their cost of production.

Zoe: In principle, Nash should be a strong competitor because production costs seem to be lower, they are using a more efficient production technique. But it seems that they are struggling to secure access to retailers because of the rebate schemes. So what they've started to do is use smaller retailers and the internet as a means of getting access to consumers. But then obviously those distribution channels are limited in terms of growth prospects and volumes.

Jib: And consumers actually confirmed to us that they prefer to buy from retail distribution. The reason being that they want to see the products live before buying and they value customer service. By foreclosing Nash from this retail network they have actually increased (Nash's) cost of display and distribution. Nash indicated to us that their decline in sales have resulted in them operating below optimal capacity which has increased their cost.

Kate: Well that's excellent, I think we can put all of this to them when we meet with them next week.

Slide 26

Amelia Fletcher: In this scene we saw the competition authority summarizing the evidence they have gathered to test the claims made by the complainants, and the theory of harm. Prices have increased following the introduction of the rebate scheme. Of course, the agency would want to make a careful causation assessment here. Did prices increase for reasons other than the alleged conduct? It seems in this case that they were not driven by increased costs, but could there be other factors?

Another question that would need to be asked is "Why couldn't Nash just undercut or match the overall deal offered by Stanmore and Richmond to retailers, and get retailers to switch to Nash?" Is there a reason perhaps due to customer loyalty for Stanmore/Richmond products? What does seem clear here is that this doesn't seem to be a case of an inefficient competitor being out-competed. Nash is actually apparently quite efficient, although they are being forced to operate at a less efficient point in the supply curve.

Are there though, efficiencies that might be driving or justifying this conduct that should be weighed in the balance? I'm now going to turn to Andy Gavil to discuss this issue of efficiencies in some detail.

Slide 27

Prof. Andrew Gavil: In our earlier segment, we talked about anticompetitive effects, and how the agency would analyze anticompetitive effects. But as we also indicated, the analysis of competitive effects is not complete without a consideration of procompetitive effects as well. So what do we mean by procompetitive effects? Typically we talk about efficiencies. And they're usually the most prominent pro-competitive effect considered in competition analysis. You would look at lower cost, perhaps in production or distribution, but conduct might also result lower transaction costs, which would be beneficial to competition and consumers. We might consider new or superior products or services. That too, might be attributable to the conduct. Innovation, innovation and distribution or the product itself could also lower cost or facilitate the introduction of new products, or make the production and distribution more effective and efficient. And finally, conduct might improve market incentives, such as correcting for market imperfections. An example often cited is the free rider effect in intrabrand competition.

What would be the consequences of these kinds of procompetitive effects. Unlike market power, which creates incentive to raise price, the consequences here might be to create incentives to lower price and to compete more aggressively. Lower price might also mean lower quality adjusted prices, such as for example when the quality of the product is improved, even if the price stays the same, from the point of view of consumers, it's a lower price. Diminished incentives to coordinate with rivals, diminished incentives to exercise market power and diminished incentives to

try to exclude rivals might also result from these kind s of efficiencies, because they might include incentives to compete more aggressively with their rivals.

Slides 28

Prof. Andrew Gavil: One way to think about and conceptualize, pro-competitive facts, is to think of their impact on the incentives of the firm pushing them toward upward pricing or downward pricing. For example, if a firm is thinking about exercising market power, it will consider whether or not raising pricing and reducing output, losing customers will prove to be profitable as a strategy. Will the increase profit from those customers that continue to buy outweigh the lost profits from those customers that discontinuing buying. They might also consider however, the impact of downward pricing pressure, if efficiencies suggest the possibility, of lowering price and expanding output that to requires a calculation. Will that incentive lead to an interest in lowering prices that will depend on again the profit calculation. Will expanded output at a lower price lead to greater profits? Often in the analysis of competitive effects, we need to consider both the incentive to raise price and the incentive to lower price and upward price pressure and downward price pressure are useful tools that economist use to evaluate those competing incentives.

Slides 29

Prof. Andrew Gavil: It also leads to easy and hard judgments. Let's think about for a moment easy cases and hard cases that may face the agencies. An easy case for enforcement will be a case where we have an abundant evidence of actual or likely anti-competitive effect and perhaps little or no evidence of significant efficiency, an easy case against enforcement would be a case where we have very little evidence of anti-competitive effect but perhaps some or even abundant evidence of efficiency. Whether the hard cases in competition policy, the hard cases are the ones the present both kinds of effects and reasonable both incentives may be at work. Perhaps there's significant evidence of both, anti-competitive effects and incentive to exercise market power but there is also significant evidence of potential downward pricing pressure owing to efficiencies associated with the conduct. At this point, the wing of the evidence becomes critical. One way to think about these hardest cases is to think about the incentive to exercise market power, the upward pressure on price and also the downward pressure on price that may be brought about by evidence of efficiency. The agency needs to make a prediction, about which of those will be the predominant effect. They typical don't try an quantify and measure and then balance determining which is the measurable greater effect, but they do evaluate the likely predominant incentive. Will be the raised price or will be to compete aggressively?

Slides 30

Prof. Andrew Gavil: Finally, let's think about how the agency is going to approach this question of pro-competitive effects? What kind of evidence will it be looking for as it evaluates the justifications being offered by X and Y? Well, first it may consider whether those justifications are really even cognizable or recognizable as sufficient justifications for anti-competitive conduct. If there, investigation so far suggests that the conduct may indeed lead to anti-competitive effect, what kinds of justifications might tend to dissipate the incentive to raise price. The may look at whether or not the justifications offered are really plausible, are they based on sound economic theory but also are they based on evidence, are they supported by evidence and will they be of sufficient nature that they might actually dissipate the complete incentive to raise price. For example, if could be that there are some justifications, some reasons to think that the conduct will reduce cost but that those reductions will not be sufficient to really counteract the incentive to raise price. As we go to the next scene, consider how the agency evaluates both anti-competitive effects and pro-competitive effects. What kind of evidence do they look at and how do they evaluate the competing evidence of anti-competitive and pro-competitive effects that may result from X and Y conduct.

Slides 31

Kate: Thank you very much for coming in today, as you know we've invited you here because we have some fairly serious concerns about the loyalty rebate scheme that you and Stanmore have introduced. Can you explain your reasoning behind this scheme, please?

CEO: Yeah, sure. We want retailers to invest in our brand. As soon as we launched this scheme, retailers were very happy with it and a number of them joined immediately. We see a number of benefits from retailers investing in our brand. First of all, it means that retailers understand the products that we offer, it means that they're able to provide a better service to consumers, and in order to make that investment worthwhile they need more retail space in order to be able to stock a good range of our products. That's really the key to success in this market, otherwise you won't sell any products.

Kate: The rebates that you are offering are quite significant aren't they, so that must cost you quite a bit?

CEO: Well it does cost money. But retailers are investing in our brand and that's really important if you are going to sell high-end flat screen TVs. From a strategic point of view it makes perfect sense to encourage retailers to understand and market our products.

Jib: And it looks like you put up prices at the same time (as Stanmore). Was that part of the same strategy.

CEO: Well we've been trying to increase demand by offering more display space and better service. All of this means that customers benefit because they get a bigger range of our products and better service. Of course, that does have its costs.

Zoe: I mean, you said that customers benefit but we've actually received a significant number of customer complaints about this. In particular the higher prices, less choice, and that Nash is no longer stocked. So this doesn't really look like the good outcome for consumers that you are suggesting.

VP: Well that really wasn't the intention behind the scheme. It was really to increase our sales in competition with Stanmore and Nash, not about removing choice.

Kate: But there's evidence to suggest that this wasn't about you competing with Stanmore. As you know, we visited your offices earlier this year, and we came across an e-mail from you to the CEO of Stanmore…and I quote: "Dear Bob, attached please find template as discussed. Price adjustment will be in 4 weeks time. Treat strictly confidential." So, that would appear to show that you're agreeing with Stanmore to introduce similar schemes and similar price rises?

CEO: Well you have to understand that we and Stanmore have quite similar business models. We both succeed in this market by selling our products through investing in our distribution network, and making sure that customers get really good service at the point of sale. Nash has a completely different business model. They don't make that investment and all they're doing is free-riding on the investments that we have made.

Jib: So, is this why you introduced the scheme?

CEO: We introduced our scheme because we want to improve the service that we offer to consumers through our retail network, and protect the investment that we have made in that network.

Zoe: We've got a copy of an internal memo from your VP to you which regards this loyalty scheme and it does specifically say that "we could increase the rebate by 15% for those retailers that have stocked more of Nash's products in the past."

Kate: And this evidence would seem to suggest that you were deliberately planning to foreclose Nash's access to retailers, in agreement with Stanmore, and that you were planning to share information in order to coordinate a price increase. Both of these activities are anti-competitive, as you probably know, and have harmed consumers by restricting choice and increasing prices. So, I would like to hear what you have to say about that…

CEO: Well, we've explained our reasons for doing this, and also why we think consumers benefit. I think if you want to read something different into it, then that's

up to you. But I've made very clear why we think this is the right strategy for our business.

Slide 32

Amelia Fletcher: This scene showed the competition authority putting substantiated concerns to the parties and allowing them to respond. Whenever an agency is relying on a theory of harm it is important in investigations that the parties are given a chance to respond. In this case, the competition authority, having heard all the evidence, decided that the balance of evidence demonstrated that the conduct was anti-competitive.

But, this was a hypothetical case, and admittedly a stylized one. Other cases might feature other issues like countervailing buyer power, or other mitigating factors, .

Let's now hear from some agencies around the world on some of their practical case experience.

Slide 33

Jaime Barahona (FNE Chile): At FNE we are trying to introduce competitive effects analysis on mergers and abuse cases also. Often this is not a very task in countries like Chile because of the lack of public information that can be used for the assessment of the cases. Also the information that can be gathered from the parties or third parties often have errors or miscalculations so considering the time constraints we have to take steps from the beginning of the investigation in the planning of what sources we are going to take into consideration and what data we are going to request.

One area more consistently, we are making use of analysis of competitive effects is merger cases and these case parties are more willing to collaborate with us and to report and forward information that is relevant to the case. Regarding a particular case, we would like to explain what we did on a merger case regarding supermarket industry. In September 2010, the Fiscalia submitted to the competition tribunal a final decision or final assessment of a case, it dealt with a takeover corporation of the largest wholesale distributor of groceries and other products, Alvi, by a large supermarket chain, D and S. What we did was a competitive effects analysis was the data that we obtain from the first part of the operation and from third parties. We used monthly price data from various D and S stores, the supermarket chain that was acquiring Alvi, around Santiago and was controlled on the basis of proximity of an Alvi store in order to measure the intensity of competition with and without the presence of Alvi.

Two different models were tested in this analysis. The first one, we used price data. This price data was explained by four variables, the presence of an Alvi store in radius of 5, 10, and 15 minute drive the number of competitors in the same radius

and the type of supermarket, hypermarket, express or basic and also the type of area. In the second model the number of competitors were replaced by the local market concentration indices.

So some interesting results came out of these analysis. It was suggested the presence of Alvi did push prices down, especially in low-income areas. We detected that low income customers were very fond of buying in these distribution and wholesale premises because of low cost and quantities that could be brought by them. So after this analysis our report was sent to the competition tribunal and a case was opened. Regardless of that, after our report the parties announced that they would not continue with the offer.

Slide 34

Lilla Csorgo (New Zealand Competition Commission): So our topic is, countervailing power vs. monopsony power. This issue arouse in a recent application to the Commission by Fonterra which is a dairy producer and also one of New Zealand's largest exporters. What Fonterra was proposing to do is to form a buying group through its logistics arm Kotahi, but what Kotahi was going to do is purchase transportation services on behalf of other exporters, so rail, trucking and really the main focus being ocean freight services provided by shipping companies.

So the question that the commissioned faced from a legal perspective was whether Kotahi is a buying group for exporters would result in a lessening of competition, and if did result in a lessening of competition, whether the detriments of that would by outweighed by the net public benefits. From an economics perspective, the question of whether Kotahi is likely to result in a lessening of competition was really a question as to whether it would be result in countervailing power or monopsony power. So if it were just countervailing power, this actually would be viewed as efficiency enhancing by the Commission. If it is monopsony power on the other hand this would have been viewed as efficiency reducing.

Slide 35

Lilla Csorgo: So, what is the difference between the two? Countervailing power is exactly what it sounds like, what it is, is that the buying group is able to countervail the upstream market power by the suppliers in this case, the trucking companies, if indeed they do actually have market power, the rail companies or as I said the main focus being the ocean freight service companies. In that case what we have is depression in price, but the depression in price is not so low that it falls below competitive levels. And because we have a price decrease, and as in most cases when we have such a price decrease, it is associated with an increase in output. This increase in output is efficiency enhancing.

Slide 36

Lilla Csorgo: On the other side, if we actually had monopsony power -- so the upstream supplier of the good doesn't have market power and the price that the good is actual sold at is the competitive price -- if we a have further depression in prices of the result of the buying group the price falls below competitive levels and we actually have that associated with a decrease in output. This is because now it's the supply curve that's dictating the amount of output that actual comes onto the market and prices now below competitive levels, and suppliers are not getting a competitive return, and so their actually going to withdraw product from the market. Some supplies might exit or they just reduce the amount of output they make available or they could actual decrease the quality of the goods so long the quality adjusted basis we still have this decrease in output.

Slide 37

Elisa Mariscal (Mexican Federal Competition Commission): I will be talking about carbonated beverages case that we recently decided in December 2011. This is a case where we focused on the effects of conduct in the market place. The cases involving carbonated beverages have a long history in the Commission. The first was bought in 2000 by Pepsi against Coke, the second in 2003 this was Big Cola against Coke, and this is the most recent one, 2008 Pepsi against Coke again.

And this complaint was admitted in 2008, and among the evidence that Pepsi presented were 300 sworn affidavits by local store owners that talked about exclusive agreements between Coke and these local store owners. It's particularly hard to find harm from 300 affidavits in a market that includes more than a million points of sales and that represents 70% of carbonated beverages sales in Mexico.

Coke does indeed have a dominant share of the market, 80% of the market is held by Coke, and an additional difficulty is that not all of the players in these markets are structured in the same way or have presence nationwide although the case was brought as a nationwide case. The Commission decided to launch a full scale investigation in part to set some evidentiary standards both within and outside of the Commission.

The technical problem that the Commission faced was to determine whether this conduct was indeed wide spread or if it was isolated local and really did not account for harm or widespread harm at least and to determine if this conduct had the effect of excluding rivals or foreclosing the distribution channel regionally. And to do this the Commission sought to build a test that would show whether the economic agents in the market were able to obtain a size or scale that made them a viable long term competitor.

The test consisted of three distinct parts the first was to determine whether under normal conditions an entrant was able to become at least as efficient as a government player or at least to have the possibility of obtaining an efficient production level. The second was to determine whether this conduct was prevalent

in the market and the final part of the test was to look at whether the dominant firm was able to maintain or to increase its dominance thru the use of these exclusive agreements.

We built the test by determining whether the entrant was able to reach a minimum efficient scale. This minimum efficient scale, as you will see, is the lowest point of the average total cost curve, and we were looking at whether with some degree of confidence, we would be able to say if this agent was to the left of the lowest point of the average total cost curve, or if he was to the right of this average total cost curve. If the agent was to the right of the average total cost curve, we would determine that the agent was able to obtain a scale that would allow him to have long term viability if he was to the left this would not be the case. And then after we calculated this average total cost curve with data from the industry as a whole, we then compared the regional data for individual agents to this industry-wide nation average total cost curve and looked at whether the agent would be able to continue in the market as an efficient player.

We found that in most cases the complainant was able to obtain this minimum point and that in those cases were the agent was not able to obtain a minimum efficient scale this was true for all agents in that region and it was mainly due to geographic reasons in that market.

In addition, the Commission obtained funds to hire expert draft guidelines on survey to sign and agents were free to decide whether or not they wanted to present survey results as evidence. But the Commission did use these survey results to obtain indirect evidence on the affidavits and to determine whether these affidavits were representative of conduct in those locations. And we found that in most of those locations exclusive agreements were not common and that even in stores were these exclusive deals had been found, these were short lived. After a certain amount of time these store no longer had exclusive agreements. Finally, we did not observe that the dominant agents was increasing its dominance as a result of isolated exclusive deals. And with this evidence the plenum voted in December to unanimously close the case as there was not enough evidence to find competitive harm.

Slide 38

Amelia Fletcher: As you can see, competitive effects can arise in a variety of different circumstances and cases.

We hope that through this module you will have learned more about the effects-based approach to competition policy and enforcement, how it is done in practice, and what some of the important considerations are.

Thank you.