

**Dominant Firm Behaviour under UK Competition Law**

**by**

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## **1 Introduction**

Many countries have legislation designed to prevent monopolisation of markets or the exploitation of market power; and there is, unsurprisingly, a large measure of overlap in the thrust of the different legislation and the underlying economic reasoning which that legislation is designed to reflect and implement. These include, inter alia, the ways in which markets are identified and quantified; how market structure can be measured and assessed, and its relevance to market power; and what constitutes anti-competitive behaviour or abuse of dominance and how these can be identified. Equally unsurprisingly there have been a number of differences between regimes as to how some of these matters should properly be understood, leading in recent years to some lively and, I believe, very constructive debate as to what constitutes best practice, with many of us here learning from others' experience. This has become all the more important as international or global mergers have required convergence in economic thinking on mergers, much of which is directly relevant to the economic analysis of positions of market power.

Procedures have also differed across national boundaries. As one of a growing number of those heading competition authorities with an economics background I, perhaps inevitably, tend to think that substantive differences of economic analysis are more serious than difference in the processes by which the essentially economic judgements are made; but must concede that procedural differences are large, have generated very considerable debate and, in the end, do have the capacity significantly to affect the substantive judgements emerging from different regimes.

Overlapping these general observations, it must be said that the UK regime, to which I turn in a moment, has been going through radical change. In a number of important respects it differs from the US or EC regimes. This has, in fact, been true since 1948 when the UK first introduced a competition regime. But up until 1998 this reflected the accidents of history and culture, and a significant degree of insulation of different regimes. The unique features of the

new regime that have emerged since 1998 are different in two respects. First they to some extent reflect what has been termed a 'magpie' approach. As the magpie bird thieves beautiful objects from wherever it can find them and uses them to line its nest, so the UK has plundered observable best practice from elsewhere, creating a regime that mirrors no other, because it seeks to combine the best elements of other regimes without their drawbacks. But, second, in one or two important respects it seeks to address, in pursuit of a robust competition regime, what arguably are potential weaknesses elsewhere. These embrace both substance and procedure.

My purpose today, therefore, is briefly to convey what has been happening in the UK and why. Where the UK regime differs from other regimes, most notably the US and EC, it is not by accident or ignorance, but as a result of using the luxury of a major reform of the UK regime to absorb the best of both, plus a few unique UK elements, the rationale for which is given below.

Section II provides the bare bones of the changes which have occurred in the UK. Section III looks at economic issues, based in part on the substantial economic guidance which the authorities have been required by statute to publish on how market power issues are to be addressed. Section IV concludes.

## **2 The New Competition Regime in the UK**

### **2.1 The UK Regime Prior to 1998**

The UK has, I believe, the longest surviving anti-monopolisation legislation in the world outside the US. Established in 1948, the UK Monopolies and Restrictive Practices Commission (as it was then called) or MRPC was charged with looking at the sort of problems its name identified. It was, however, a child of its time, largely introduced, it has been suggested, at the behest of the US, which was anxious to see a more competitive environment in Europe to which it was supplying very substantial post-war support, thus

providing an economic environment in which US firms could compete. The MRPC reflected some ambivalence as to the desirability of such an initiative (it was, after all less than 10 years since the general thrust of government policy in the UK had been to bring about consolidation of its industries in the belief that this would generate economies of scale and other efficiencies to ward off recession and compete more effectively in world markets) and was, for its time a peculiarly British institution. It was envisaged as a Commission, largely of the great and the good; with a purely advisory role. Decisions were a matter for the government. The Commission was asked to conduct only 28 inquiries in its first 17 years (in some years conducting none at all) and some individual inquiries took several years to complete. Its main achievement was to identify the need for a more formal and legally based procedure to deal with restrictive practices, which duly emerged in the form of a separate institution (The Restrictive Practices Court) in 1956.

Further reforms followed, in 1965 with the addition of responsibility for advising on mergers, and in 1973 with the creation of a separate Office of Fair Trading with, inter alia, responsibility for carrying out Phase 1 investigations into monopolies and mergers and, where necessary, referring them to the by then renamed Monopolies and Mergers Commission (MMC) for Phase 2 assessment – see below. But, and this is the point of this mini history lecture, despite these changes the original concept of the Commission as an advisory body, with Commission members from industry, public service, trades unions and the like in addition to a few lawyers, economists and accountants, persisted through to 1998.

There were clear weaknesses in this structure. The Commission had a full-time staff, including 2 or 3 lawyers and half a dozen economists, but the Commission members who actually advised Ministers were largely non-expert and part-time. Decisions were explicitly in the hands of politicians and, while increasingly it became unusual for them to override MMC recommendations, nonetheless there was clearly scope for, and frequent suspicion that, politicians could be influenced by sectoral or other business interests.

There were, however, three major advantages that, critically, have in some shape or form persisted and are reflected in the new regime. First, since long before the 1973 Fair Trading Act, the Commission had jurisdiction in respect of a scale monopoly situation, which was defined as one firm having more than 25 per cent share of supply of a product or service.<sup>1</sup> Second, it had jurisdiction in respect of 'complex monopoly' situations. This was defined as a situation in which two or more firms collectively having more than 25 per cent of a market, acted in similar fashion so as to prevent, restrict or distort competition.<sup>2</sup> This has often been regarded as a legal way of defining oligopoly. However, oligopoly is neither necessary nor sufficient for a complex monopoly. Some complex monopolies, for example certain groups of medical practitioners, or Scottish estate agents (realtors) have been found to be complex monopolists even though there were many hundreds or even thousands in the market. Equally, some highly concentrated markets are not complex monopolies because the participants do not prevent, restrict or distort competition. Nonetheless, the UK has had an explicit means to tackle oligopoly since 1948, many decades prior to the tortuous development of the concept of collective dominance still under active debate in the EC, and with a threshold substantially below the (until recently) conventional threshold of 40 per cent for dominance in the EC.

This interacts with the third big advantage of the UK historically, namely that although remedies did not include fines, as no prohibition had been breached, they could include both behavioural remedies designed to alter company behaviour, or structural remedies which could force companies to divest activities or more generally be split up, a response to market

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<sup>1</sup> Fair Trading Act 1973: Section 6, reproduced in Appendix 1, of the Act defines monopoly situations in relation to the supply of goods. Section 7 is similar but refers to the supply of services.

<sup>2</sup> Fair Trading Act 1973: Section 6(2) of the Act, reproduced in Appendix 1, gives the primary definition of a complex monopoly.

power which the US regime permits but which (again until recently) it has been presumed by many was not open to the EC authorities.

## 2.1 The New Regime: The 1998 Competition Act

By the end of the 1980s and increasingly through the 1990s, substantial dissatisfaction with the regime arose, for four main reasons. First, although the Restrictive Practices Court had led to the wholesale abandonment of restrictive agreements in the UK in the 1960s, it was essentially form rather effects based, and so was seen as increasingly ineffective against certain types of co-ordination that had the effect of cartelisation but could not be prosecuted because they were expressed in a form which the legislation did not prevent. Second, there was increasing awareness that some types of exploitation of market power, for example predation, some types of price discrimination, various exclusionary tactics and the like could, on economic grounds be regarded ex ante as objectionable, and should therefore be prohibited, but which under the then existing legislation could only be addressed, case by case, after an MMC inquiry. Third, there was a growing wish to bring about much more consistency with the EC regime which, via Articles 85 and 86 (as they then were, now Articles 81 and 82) provided a much more effective anti-cartel regime as well as an ex ante prohibition regime for abuse of dominance. Fourth, it was increasingly regarded as undesirable that decisions designed to deal with market power should lie with the government of the day.

Out of this emerged the first leg of the UK reforms. The 1998 Competition Act created a so-called Chapter I prohibition which is a domestic, but otherwise virtually identical prohibition to Article 81, prohibiting anti-competitive agreements; and a Chapter II prohibition which is a domestic but otherwise virtually identical prohibition to Article 82, prohibiting abuse of

dominance.<sup>3</sup> In each case fines up to 10 per cent of revenue, for up to 3 years if the prohibition has been breached for that period, are payable. The legislation is applied and enforced by the UK Office of Fair Trading (OFT), independent of political influence. Companies have the right of appeal against OFT findings and/or fines to a newly created Competition Appeal Tribunal (CAT). This was initially part of the MMC which, in recognition of the new powers, changed its name (again) to the Competition Commission (CC). However, the CAT operated as a separate unit under its own President, who must be (or be equivalent to) a high court judge, with the first President being Sir Christopher Bellamy, until then a judge at the Court of First Instance (CFI) in Luxembourg and therefore very experienced in hearing appeals against decisions of a competition authority. The UK's Restrictive Practices Court was abolished.

At a stroke therefore, both anti-cartel and anti-monopoly policy had been given new teeth; a major step had been taken to harmonise UK legislation on both cartels and abuse of dominance with Brussels; and the implementation of both had been further removed from government ministers. Section 60, at a high level, imported all previous EC jurisprudence in these areas into the UK regime, immediately establishing a relevant track record of precedent.<sup>4</sup>

It is probably fair to say that progress in using the 1998 Act to tackle competition problems has been fairly slow. The Act only came into force in March 2000 (to provide time for industry to become familiar with the new provisions and put compliance programs in place).

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<sup>3</sup> Competition Act 1998: Sections 2 and 18 of the Act, reproduced in Appendix 2, specify the basic prohibitions involved in Chapters I and II. Sections 3 to 11 (not reproduced) deal with exemptions from the Chapter I prohibition. There are no exemptions from Chapter II, but section 19 (not reproduced) refers to 'excluded cases' which refers to such matters as merger situations, planning agreements, markets regulated by European authority, etc; see also The Chapter II Prohibition, OFT 402, 1999.

<sup>4</sup> Competition Act 1998: Section 60, reproduced in Appendix 3, of the Act.

Potential infringements, by their nature, take time to identify; and this must be followed by substantial data gathering and due legal processes. Inevitably various sorts of interim challenges to the OFT have been brought before the CAT as everyone involved attempts to identify the economic dimensions and legal limits of the new regime. That said, a number of cases have now been completed<sup>5</sup> with increasingly large fines imposed, and there is no reason to think that the Act will not, through time, be a major plank in the attempt to create a fully competitive economy in the UK.

## 2.2 The New Regime: The 2002 Enterprise Act

It might be thought, and indeed was argued by some, that the 1998 Act made the previous legislation on scale and complex monopoly redundant. However, this view did not prevail. The alternative view, which led to retention of this earlier legislation, can be summarised in three contentions. First, there is an important distinction, indeed it increasingly appears to be an absolutely critical distinction, between *anti-competitive behaviour*, of the sort which the EC regime, the UK 1998 Competition Act and many other regimes around the world seek to prohibit as being *ex ante* detrimental to competition and consumer welfare; and *uncompetitive* behaviour, where no *ex ante* prohibition is breached but where competition in a market is nevertheless not fully effective. This may arise because of other features of a market besides any anti-competitive conduct of the firms involved (see below); or because of the *absence* of fully competitive conduct, be this in terms of prices, cost efficiency, product quality or development or other types of innovation. If there is a substantial degree of uncompetitive behaviour, so defined, in an economy then it represents a problem which legislation designed to prohibit anti-competitive behaviour cannot address.

Second, it was far from clear in 1998, and in some respects is still not clear, to what extent the concept of collective dominance can be defined and used to deal with problems of

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<sup>5</sup> Competition Act 1998: Appendix 4 lists companies which have been fined by the OFT.

oligopolistic market power. Of particular significance, oligopoly can frequently create incentives such that individual companies, each separately pursuing their legal obligations to their shareholders, are very likely to generate uncompetitive outcomes yet cannot easily if at all be said to be acting in breach of the law on anti-competitive practices. This is elaborated upon in Section III. Given this, it was seen as vital that the complex monopoly provisions of the 1973 Act be retained.

Third, as noted above, under the UK's monopoly provisions of the 1973 Act, structural and behavioural remedies could be adopted. Though there is some current discussion on the extent to which, if at all, such remedies are available to the EC, it has historically been assumed, and may still be the case, that no such remedies, as opposed to fines, are available under Articles 81 and 82. In the UK, there are order-making powers in relation to Chapters I and II to bring breaches of the prohibition to an end, but it remains untested to what extent this could include behavioural or structural remedies.

As a result, the UK retained its scale and complex monopoly provisions after 1998, (together with the merger legislation which accompanied them) the only concession in the 1998 Act being guidance (but not binding legislation) that in the case of single firm dominance, the OFT would normally use the 1998 Act rather than the scale monopoly provisions of the 1973 Act. Only if, for any reason, a finding against a single company under Chapter II failed to rectify the situation might the OFT make a scale monopoly reference to the CC.

In many ways the immediate post 1998 position in the UK looked rather attractive from an anti-trust perspective. The UK had cartel and dominance provisions explicitly modelled on, and potentially every bit as effective as the EC regime; but, like the US regime it also had statutory provisions to carry out somewhat wider inquiries which could result in behavioural remedies or, in the limit, structural ones. There were, however, perceived to be three remaining flaws in the UK regime. First, the CC remained advisory, with Ministers still

explicitly responsible for merger and monopoly decisions. Second, there was growing recognition that fines might not be as effective a deterrent as could be wished because, at the end of the day it is either shareholders or consumers rather than managerial decision-takers who bear the fines. This focused attention on US provisions which enabled those found guilty of anti-competitive conduct to be jailed.

Third, more arcane, but critical to achieving a fully modernised and robust regime, there were important elements of the wording of the complex monopoly provisions, which not only created a series of tortuous legal hurdles which had to be overcome to reach a complex monopoly finding, but also in principle limited the scope of the authorities to intervene. This limitation had clearly been acceptable in 1973 but increasingly was not regarded as so 29 years later.

Out of these concerns emerged the 2002 Enterprise Act. Addressing the points noted above, the 2002 Act first, modernises the complex monopoly provisions, in terms of so-called market investigations. In investigating a market the CC is required to decide whether there is an 'adverse effect on competition'. This arises whenever 'any feature of a market, or combination of features, of each relevant market prevents, restricts or distorts competition'. Where an adverse effect is found, behavioural or structural remedies may be applied.

There are two critical differences between this and the previous FTA provisions on complex monopoly: (i) under the complex monopoly provision, a restriction prevention or distortion of competition was a *jurisdictional* point. Unless such effects were found, the Commission had no jurisdiction. Equally if it did find such effects it had jurisdiction but such a finding was explicitly not in itself an adverse finding. It was a quite separate question under the Act as to whether any such restriction, preventive or distortion had an "adverse effect on the public interest" and, given this explicit separation, it was always open to companies to argue that a restriction, prevention or distortion of competition was not in itself sufficient to reach an

adverse finding. Thirty years on the new Act *equates* any such effects on competition as adverse. (ii) Under the complex monopoly provisions, firms had to be engaged in *conduct* which prevented, restricted or distorted competition for there to be jurisdiction. In the 2002 Act 'any feature' of a market which has this effect is sufficient. This may include firms' conduct but could include aspects of market structure, barriers to entry, switching or search costs, or other causes of consumer inertia, absence of adequate information or asymmetries of information, etc and could also include conduct of any person rather than just those carrying on a business. To use the distinction introduced above, this addresses various potential causes of lack of competition, ie uncompetitiveness, as opposed to only anti-competitive conduct. In short the first element of the 2002 Act was to modernise and strengthen one of the key distinctive elements of the UK regime.

The second element was, in almost all circumstances, to take Government Ministers out of all such decisions. Thus, where the OFT, having carried out a phase I inquiry, refers either a merger or a market to the CC, the CCs decisions and remedies will normally be determinative, subject only to judicial review by the CAT, which has therefore now been split off entirely from the CC. The only exceptions are where a case raises issues under so-called public interest gateways, in which case, to the extent that there is any finding under such a gateway, final decision taking power reverts to Ministers. However, initially there will be only three such gateways, one relating to national security, and the others relating to plurality of view in respect of the press, and plurality of control in respect of media; and only the first of these will apply to market inquiries. None of the non-competition issues that can emerge in such cases, for example concerning employment, the environment, social policy matters, regional issues etc are admissible unless a new relevant gateway is created. This requires a statutory instrument to be approved by Parliament, which is a significant barrier, and the government's stated policy is that such matters, clearly of considerable importance, should and will be handled via explicit policies (employment, social, regional, etc) and not under the umbrella of competition policy implementation.

The third element was to criminalise cartel activity, so that those found guilty are liable for up to five years imprisonment. This was based on a favourable view of the role of such provisions in the US. Prosecution will be carried out by the Serious Fraud Office. In addition, the OFT has adopted the US leniency program, under which the first corporate whistle-blower on a cartel will get automatic immunity from fines and a subsequent whistle-blower some discretionary immunity but no immunity for other cartel members. A separate leniency program operates for individuals facing criminal charges.

The Enterprise Act came into force on 20 June of this year. The resources of the OFT and CC have been substantially expanded. A large number of economists, lawyers, accountants and industry experts have been recruited to the staff of the CC, predominantly from the private sector, and there has been a heavy focus in the appointment of Commission members on the relevant expertise. The first (merger) case to be heard by the CC under the new Act was referred on 22 August (an earlier merger situation was abandoned on referral). It is, of course, therefore much too soon to identify the impact of this legislation on uncompetitive markets. But the combination of the 1998 Act prohibiting cartels and abuse of dominance, with the threat of fines, the 2002 Act authorising investigations into mergers and markets, with behavioural or structural remedies, and the criminalisation of cartels, all implemented by the independent authority of the OFT and CC with an independent appeal body in the CAT, represents, in my view, one of the strongest if not the strongest anti-trust regime in the world, capitalising on the EC regime but with very important elements of the US regime included. Apart from the EC 'modernisation' initiative in 2004, which will involve a substantial degree of delegation of EC competition powers to national authorities, the 2002 Enterprise Act completes, for the foreseeable future, the UK's competition policy reforms.

### **3 Economics**

So far I have almost exclusively covered legislation, institutional arrangements and procedures, and these are the main focus of many international conferences on anti-trust issues. But, as I hope we all agree, the core issue is the economics. What structures and conduct are problematic; how are competition and the intensity of competition both currently and in the future, to be assessed; and in what circumstances are certain practices acceptable but in other circumstances not acceptable in terms of competition and consumer welfare. Indeed, are these two synonymous or not, and if not how should they be weighed? A requirement in both the 1998 Competition Act and the 2002 Enterprise Act is that the OFT and CC must publish guidance on a whole range of procedural and substantive matters, including an explanation of the criteria and assessment methods which the OFT will use in Chapter I and II cases; the basis on which it will refer merger and market cases to the CC and, in the case of the CC, the basis on which it will reach its findings in such cases. (Copies of the guidance on Chapter II and on market inquiries are available on request.) This guidance is quite extensive, covering at least to some degree all the major issues which experience suggests are likely to emerge in such inquiries. Here I focus briefly on four such issues.

### 3.1 Competition Versus Consumer Welfare

One of the curious aspects in the development of competition regimes around the world is that there remain substantial differences of view, sometimes explicit but often rather more implicit, as to the basic or proper purpose of such regimes. Three schools of thought are discernible. The first, which includes a number of economists, argues that the fundamental objective should be maximisation of total surplus, it being a separate and purely distributional issue how the maximum which can be obtained from the economy's resources should be spread across different groups of consumers and businesses in society. While there is a clear economic logic to this, no regime as far as I am aware, reflects this position, not least because of the absence in many cases of any practical or politically acceptable mechanisms for achieving any subsequent re-distribution of, in particular, producer surplus.

The second approach, in effect, gives a zero or near zero weight to produce surplus, and hence sees the fundamental objective as maximising consumer welfare. Some commentators have in recent years increasingly characterised the US regime this way, seeing various anti-trust decisions as reflecting a prime concern with consumer detriment. On this approach it matters less what market structure exists, whether there is in principle a degree of market power or precisely how firms have behaved (and some might say these do not matter at all). The essential question is whether consumers have been harmed. If not there is, arguably no cause for intervention.

The third approach focuses more specifically on competition; on the structural features of a market, the conduct of firms, the light thrown on the competitive process by firms financial and other measures of performance, the interaction of all these and hence the overall competitive dynamics of a market. This approach sees competition as quintessentially a process of rivalry through time with the basic objective of competition policy being to defend and maintain (some might say 'promote') this process of rivalry. Though it is a little simplistic it may be said that the consumer welfare school sees consumer welfare as an objective in its own right, with competition as one of the means to achieve it. The competition school sees competition as so fundamental to consumer welfare, not only in terms of minimum prices, good quality and the like but in terms of the choice which only competition can bring, that maintaining a healthy process of rivalry becomes a policy objective in itself.

This does not exclude allowance for relatively rare cases where consumer welfare might be harmed by competition and, in that sense, consumer welfare remains the ultimate good; but there is still a big difference between regimes that require evidence of consumer detriment before acting, and those that require only evidence of detriment to the competitive process.

In the old UK regime, all decisions were ultimately based on an explicit 'public interest' test. While the relevant statute (section 84 of the Fair Trading Act) referred explicitly to competition and consumer welfare aspects, other factors such as employment were also referred to and, in any event, the Commission could go beyond to take into account any matter it deemed appropriate. While in practice it rarely strayed outside competition or consumer welfare issues, the regime was clearly capable of the very broadest interpretation.

The new regime for mergers and markets, though in practice unlikely to be very different, conceptually is very different, and the criteria are quite explicitly competition based. The now familiar 'substantial lessening of competition' (SLC test) is introduced for mergers and the adverse effect on competition (AEC test) noted earlier is introduced for market inquiries. While offsetting consumer benefits can be allowed for in remedying such effects, the driving motivation of the new regime is competition itself.

It follows from what I have said that this is not uncontroversial, but reflects a major concern of the UK government that the UK should continue to move forward to become as competitive as possible.

### 3.2 Co-ordinated Effects

Many markets are oligopolistic, and such markets can generate significant competition problems. Historically many competition regimes have not addressed these other than in relation to cartel activity, the UK as noted above being a rare exception via its complex monopoly provisions. The EC has moved to embrace this via the concept of collective dominance, while it remains to be seen how effectively non-collusive oligopoly problems can be addressed before US courts.

The CC's new guidelines on co-ordinated effects have now been published.<sup>6</sup> (The EC has also recently drawn up a second draft of its approach to mergers though the actual wording of the merger test it will apply and upon which the guidance is meant to elaborate, has not yet been settled as between continuing with a dominance based test or introducing an SLC test.) This area, familiar to economists for 30 years or more, is now, fortunately, fairly familiar to competition law practitioners. I focus here on two points only.

First, a number of reasons have been given for regarding co-ordinated effects analysis as at best unreliable and at worst incapable of application.

- i) Whereas basic so-called Cournot price behaviour suggests that market prices will be higher in more concentrated markets despite the absence of collusion, basic Bertrand price behaviour predicts competitive price levels irrespective of market structure. This, it is argued, is at the very least a source of indeterminacy but, beyond that, it is often argued that because Bertrand behaviour reflects competition in prices, Cournot competition in quantities, the former seems much more realistic, and so in practice there is unlikely to be any relationship between concentration or, therefore, oligopoly and excessive pricing.

However, this is in my view, a common fallacy. For a given demand relationship between price and volume, choosing a price and choosing a quantity amount to the same thing. The key difference between Cournot and Bertrand is that in Cournot, a change of quantity is assumed to trigger no quantity responses from others, so prices adjust to the new total quantity, whereas in Bertrand a change in price is assumed to trigger no price response from others. With a reasonably homogeneous product such an assumption would always result in a prospective price cut appearing to be profitable because most or all demand would switch to the price cutter, and it is this which generates the Bertrand outcome. But once the

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<sup>6</sup> Competition Commission Guidelines: Market Investigation References, 2003; see also OFT: Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act, 2003.

distinction is specified properly it is clear that in many cases it is the Bertrand assumption – that I can undercut you and take substantial demand away without any price response from you – which is quite unrealistic and can in many cases be dismissed.

- ii) It is now well understood that almost any price, once it has become established in an oligopoly, may persist for some time because it is not commercially rational for anyone to depart from it (a version of the so-called folk theorem). Again this suggests indeterminacy and hence, it is argued, little if any value in the application of co-ordinated effects analysis.
- iii) To this may be added the obvious point that mere similarity of prices in an oligopoly cannot be taken as a sign of co-ordinated effects. Exactly the same is true in the case of intense competition.

However, both problems can in principle be addressed by examining the profitability of the firms involved. If this is at or close to their cost of capital, with no indication of substantial cost inefficiency, then it can reasonably be concluded that prices are at competitive levels. If, on the other hand profitability is significantly above that level then it suggests that some degree of non-collusive co-ordination is occurring.

This proposition, and the application of profitability analysis to market inquiries, is not uncontroversial, and is therefore explored in more detail in the following section. But, subject to the points raised there, these two further sources of ambiguity identified above can be addressed.

The second point on co-ordinated effects is that, as is well know, the evidence of incentives to co-ordinate is necessary but not sufficient. A well established set of conditions are

necessary (so-called facilitating conditions) if companies are to be able successfully to act on those incentives. Here I focus on two of the most critical.<sup>7</sup>

- i) There must be sufficient transparency in a market that oligopolists know when their competitors change prices or quantities and to what extent they do so, either initiating change in the market or in response to each other. In the light of this it has been argued in some cases that if prices are not known (which is often the case in business-to-business markets), or list prices are known but not discounts then co-ordination cannot be expected to occur. This, however, seems too restrictive. It is not necessary that a firm can observe competitors' transactions prices, and hence changes in them; only that it can observe them *or infer* changes in them. In particular, in an oligopolistic market experiencing fairly stable overall demand, a significant fall in one company's sales may be sufficient to infer that price cutting is being carried out by competitors. This is quite apart from the fact that in most markets, such a firm will probably be able very quickly to identify from its customers why it is losing demand, indeed customers may well take every opportunity to tell the firm the reason if it arises from lower prices now being available elsewhere. This, while it cannot be a universally true proposition, nonetheless in most oligopolies it is likely that sufficient transparency exists.
- ii) There must be some disciplinary mechanisms such that those who do depart from a co-ordinated effects equilibrium inevitably face a reduction in profitability. Here again, however, this may easily be interpreted too restrictively. Certainly no explicit such mechanism is required. In most cases it will be sufficient to know a) that competitors will undoubtedly find out about a price reduction (see above) and b) that the profit incentives then facing competitors are likely to precipitate a matching price reduction

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<sup>7</sup> Of a long list, other main factors are the ability to adjust prices fairly quickly, a reasonable degree of similarity between the products or services involved, the extent to which a competitive fringe of firms have the ability and incentive to undercut core members of an oligopoly, the existence of barriers to entry, and the overall stability, of costs, demand, and market shares.

leaving the initial price cutter worse off. This is generally all that is needed for a competitor to understand that a disciplinary response will occur.

The implication is, I believe, clear but controversial, particularly in a court based system. In most cases a sufficiently oligopolistic structure, provided there is sufficient homogeneity of the product or service, and provided of course that it is protected by barriers to entry, will of itself provide both the transparency and disciplinary mechanisms necessary to facilitate co-ordinated effects. How persuasive this is in practice depends in part on the degree of proof required. In the UK regime, an expectation, that is, more than 50 per cent likely, is required. This is, rightly in my view, significantly below any concept of 'beyond all reasonable doubt'. The CFI in Europe often refers to the 'requisite' degree of proof, but it remains unclear, at least to me, whether and, if so, to what extent this rises above 50 per cent.

To put the conclusion of this at its most controversial, oligopolistic structures generally create both the incentives for co-ordinated activity and also the two key conditions (apart from sufficient homogeneity of product and barriers to entry) which facilitate co-ordinated behaviour. This can readily and reasonably give rise to an expectation of co-ordinated effects once a market is sufficiently concentrated. Whether this is actually occurring can in principle be identified via analysis of profitability. If this is correct, then two critical questions are, first, how best to measure concentration and, second, on the basis of any such measure, what is the threshold above what one might reasonably expect co-ordinated effects.

The most authoritative statement of this is the US merger guidelines, using the threshold of a Herfindahl Index of 1800 as an indicator of high concentration (with a threshold of 1000 below which competition problems are unlikely). The UK guidance echoes these, though it stresses that such thresholds must be seen in the light of all the information, not only on

market structure but also firms conduct and performance. It is worth noting, however, that in an economy the size of that in the UK, a substantial number of markets would fail this test.

To conclude this section, I have several times noted that the line of argument is controversial. At the most fundamental level this is, I believe, because firms understandably are concerned that, in the oligopolistic structure which is the norm in many markets, and assuming that firms are not engaging in illegal cartel-type activity, entirely rational commercial behaviour, in proper pursuit of shareholders' interests, may be the basis for intervention by the competition authorities. These have substantial power to moderate behaviour or, indeed, require structural divestment when, in the vernacular, firms haven't 'done anything wrong'. Reasonable people may disagree on the appropriate response to this, but at least one is that if, nonetheless, the outcome is prices higher than full competition would generate, then this is a diminution of competition and a loss of consumer welfare which it is open to governments to regard as unacceptable, and against which it is reasonable to legislate. This rarely finds favour in conferences on competition policy, but then such fora rarely contain consumers, or their representatives, who experience the detriments involved.

### 3.3 Assessment of Profitability

As indicated above, some key problems with the analysis of co-ordinated effects can only be resolved through profitability analysis. It must at once be stressed that profits are the key signal and incentive for the proper functioning of a market economy. There is nothing 'anti-profit' about using such analysis in competition analysis even though, as is often pointed out, realised profits are an *outcome* of the competitive process rather than a *decision* (or conduct variable) in the process. More specifically, profits typically will vary though time and across companies in a fully competitive market. There is no per se reason why profits in excess of the cost of capital represent anything other than the effective working of a competitive market. It is only where profitability is a) substantially above the cost of capital b) across

most or all companies in a market over c) a sustained period of time, that concerns arise. But when this does apply then arguably it is a clear indication that competition is not working properly and is not fully effective.

The main problems are, I suggest therefore, practical rather than conceptual. In particular, how should profitability be measured, can it be targeted to the product markets concerned, and how should the cost of capital be measured. As it happens the UK Competition Commission has over a decade of experience in dealing with just such problems. This is because in the second half of the 1980s a very large number of utility sectors in the UK which previously had been in public ownership were privatised and where, as was frequently the case, this involved the emergence of private sector monopolies, individual sector regulators were established to, amongst other things, regulate prices. This included telecommunication, gas, electricity, water, airports and railways to name only some. Where price controls are disputed by the regulated companies, the CC acts as the (now determinative) appeal body, the most recent such case being the determination of charges for calling mobile phones.<sup>8</sup> Such price controls typically involve setting a price cap for five years which, on the basis of demand forecasts and an efficient level of costs and investment, is expected to generate profits on the regulated activities equal to the companies' cost of capital, thus replicating the outcome which would emerge under competitive conditions, but preserving incentives for companies to increase efficiency.

As the appeal body the CC has, across almost all these sectors, had to determine how to measure profitability, how to measure and allocate a company's capital base, and how to estimate its cost of capital. In broad terms this work has identified that in principle truncated

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<sup>8</sup> Competition Commission Report: Vodafone, O2, Orange and T-Mobile: Reports on references under section 13 of the Telecommunications Act 1984 on the charges made by Vodafone, O2, Orange and T-Mobile for terminating calls from fixed and mobile networks, 2002.

internal rate of return is the right measure; that under certain conditions long term averages of return on the replacement cost of tangible and intangible capital is a reasonable proxy; and that this can reasonably be compared to a company's weighted average cost of capital, using the capital asset pricing model to determine the cost of equity capital in the light of the risk free rate available in the market, the equity risk premium and a company's non-diversifiable risk (as measured by its so-called beta co-efficient). Though a newer initiative, the CC has applied a similar approach in recent complex monopoly cases, for example in relation to banking and supermarkets,<sup>9</sup> drawing adverse inferences only where a) profits in excess of the cost of capital are widespread in a market, persistent and substantive b) other structural and behavioural features of a market also suggest lack of full competition and c) there is clear evidence that such profits are protected by barriers to entry. Studies are in place to see to what extent the truncated IRR approach can itself be used, rather than any proxy for it. The CC's guidance makes it clear that where practical and relevant, a similar approach will be used as part of future market inquiries under the 2002 Enterprise Act.

### 3.4 Treatment of Efficiency

This has been a topic of lively debate in international conferences in relation to merger inquiries. The issue is, to what extent if at all potential efficiency gains from a merger should be treated by competition authorities as favouring a merger. This remains an important topic but for another day. It is, however, no less interesting an issue in market inquiries. To what extent should efficiencies arising from large scale count as justification for permitting any market power which also derives from that scale of operation.

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<sup>9</sup> Competition Commission Reports: Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom, 2000, Cm 4842; The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK, 2002, Cm 5319.

The UK approach is, in principle, a two-stage one, though in some cases the two stages may tend to converge. The primary question the CC must answer, as noted earlier, is whether as a result of any feature of a market there is an adverse effect on competition (AEC). To the extent that any efficiencies arising from, in particular, large scale operation actually enhances the process of rivalry in a market then it can be weighed in the balance in deciding whether there is an AEC. At the very least it would need to be demonstrated that, notwithstanding any market power which allowed prices to be increased above competitive levels, prices were nonetheless lower than in a more competitive situation because of the scale economies achieved. This is by no means sufficient, however, if the process of rivalry is nonetheless weakened as a result of the exercise of market power.

The second stage occurs in that, if an AEC is found then, in considering remedies, offsetting consumer benefits may be taken into account and these clearly could include lower prices as a result of scale economies, though any operating inefficiencies as a result of the lesser degree of competitive pressure would also need to be factored in.

The key point is that, once again prices lower than otherwise will be a necessary condition but will not be sufficient because, with an AEC, several dimensions of rivalry will often still be diminished, including the choices available to consumers concerning the number of independent sources of new ideas, new strategies, innovative products or processes and the like. This reflects that competition is, to an important extent a mechanism by which new ideas emerge and the best ones survive, only to be superseded by other still better ones. At the risk of over emphasising an old but, nonetheless, repeatable observation, when the Berlin Wall came down, West Germans were not amazed at how high prices or costs were in the East; they were amazed at the extraordinary lack of choice and poor quality of the products which were available, suggesting that this had been the real, enduring benefit of a competitive market economy. This by no means precludes an efficiency defence but

suggests, as the UK guidelines describe, that considerable caution is necessary before allowing this to offset any appreciable lack of competition.

#### **4 Conclusions**

The UK competition regime's approach to market power has a long but patchy history, with some weak elements but some quite strong ones as well. In the five years since 1998, the UK Government has substantially built on those strengths, to an appreciable degree converged on EU practice, but incorporated powerful elements of the US approach and, critically, retaining a statutory power to deal with competition problems that do not arise from an explicit breach of a prohibition, most notably in oligopolistic markets. The result, arguably, is the most powerful regime in the world for dealing with market power.

Not all will see this as an unambiguous advantage. There remains, in the UK and no doubt elsewhere, a strong strand of opinion that rejects such emphasis on free, liberalised markets, and on the competition authorities necessary to protect them, in favour of an essentially *laissez-faire* approach – leave well alone and positions of market power will always in the end be undermined. The fact that this latter stance is usually preferred by companies which otherwise would tend to be constrained by competition law does not, of itself, provide a reason to accept it or reject it. The debate is one of historical evidence, economic reasoning and political stance. But the UK, after many earlier decades of poor competitiveness and a limited role for competition policy, has now firmly set itself in favour of free and competitive markets, working effectively, as the best means to generate maximum consumer welfare.