

***Is Competition Policy Worth it?***

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## **Introduction**

There is no question that competition policy is on the agenda these days. In the UK, two major acts of legislation – the Competition Act of 1998 and the Enterprise Act of 2002 – have brought the EC's prohibition system to the UK, changed the name of the old Monopolies and Merger Commission to the Competition Commission and given it new powers. They have criminalized price fixing, created a specialist appeal and review court for anti-trust cases and eliminated the old “public interest test”, replacing it with a narrower, effects based “substantial lessening of competition” test. At the same time, the two major competition policy bodies in the UK – the Office of Fair Trading and the newly renamed Competition Commission – have expanded, developed new areas of expertise and, possibly most adventurous of all, they have both been put into the hands of professors of economics.

We are still some way into the process of bedding down the new regime, and it is too early to evaluate it fully and properly. It is not, however, too early to address the more basic, possibly more fundamental question, namely is competition policy itself worth it? However the system is designed, it consumes public resources, and it must, therefore, deliver benefits that justify this resource commitment. This seems particularly worth doing at a time when that resource commitment is increasing in the UK, and when critics of the system equate a rise in the budgets of the OFT and the CC with a massive increase in red tape and intrusiveness.

Thus, my question today is a simple one: is competition policy worth it? I will start where all professors of economics instinctively start, namely with a textbook sketch of the benefits of competition. I will then look at the kinds of benefits to consumers which have emerged from the recent activities of competition authorities around the world (concentrating mainly on the UK). The important points that I will make here are two fold: first, those benefits which have been carefully measured are of an order of magnitude larger than the costs incurred by the authorities, and, second, that many of the benefits which come from the actions of competition authorities are realized by firms and only benefit consumers indirectly. I will close with a few comments on what might be the most important – but, equally, the most elusive – set of benefits generated by the application of competition policy, namely those that occur even when the competition authorities are inactive.

### ***The benefits of competition***

Competition is a process of rivalry between firms, each seeking to win customer's business. This rivalry may occur in a number of ways – some firms compete on price, some focus on developing the quality of existing products or services, while still others use entrepreneurial or research skills to develop new products or services. When competition is vigorous, this

rivalry insures that no part of the market remains unexplored, no aspect of the offer made by producers to consumers remains untested. The consequences of this are that prices will typically be bid down to an efficient level of costs, a diversity of product offerings will come on to the market that matches the heterogeneity of consumer needs and tastes, and the rate of innovation will be high.

From the point of view of firms in the market, vigorous competition of this type is a mixed blessing. On the one hand, competition often keeps people working at their best – it provides the kind of challenge that often produces a truly innovative response, and it can bring the best out of a firm and its senior managers. On the other hand, competing in a very competitive market can be hard work, and not everyone wants to have to run at full speed all of the time. More important, and more subtly, managers in very competitive markets have only limited control over their environment. They often have to act when they are not ready, they sometimes need to do things more quickly and less efficiently than they think that they should be done. The constant striving between rival firms in a competitive market can sometimes lead to some waste and duplication, and the whole thing often seems to create a rather untidy mess. Many managers, however intellectually and emotionally committed they are to competition, know – or think that they know – that they can do better. For them, competition is not only tiring, it is also frustrating. And of course, to cap it all, profits are usually somewhat harder to earn in competitive markets than they are in more monopolistic markets.

What role does competition policy play in all of this?

Competition policy is, by design, both selective and episodic. The vast majority of markets, including some that are in fact not very competitive, escape through the net, and only a few markets come to be the subject of investigation. In the UK, well under 5% of all mergers end up at the Competition Commission, and we have been doing an average of 1–2 market inquiries a year over the past few years in a country that hosts literally hundreds of markets which might, in principle, be investigated. Further, when we do get involved in a market, we rarely stay there for very long. Although our investigations (including the preliminary work done by the OFT) might seem like an eternity to the parties concerned, we conduct our investigations and then leave the market relatively quickly (the investigations undertaken by the Competition Commission have fixed time limits), occasionally leaving a behavioural remedy in place for a couple of years. The contrast with regulation couldn't be clearer: we do not have an ongoing brief to oversee the performance of a particular market, we do not play

a role in overseeing senior management decisions, and we do not have an ongoing responsibility for the evolution of a sector as a whole over long periods of time.

In fact, competition policy is just exactly what one might invent if one thought that markets are, on the whole, working fairly well. More interesting, and more to the purpose here, the selective nature of competition policy means that it is designed to yield large pay offs from minimal resources. Competition policy – and the Competition Commission in particular – only swings into operation when serious, egregious problems are believed to exist. Although further examination does not always sustain such fears, the existence of such fears usually warrants a further investigation. And, because it concentrates on what might be serious problem mergers or markets, when a problem is encountered, it is often quite a big one. It follows from all of this that provided the preliminary screen for possible problem mergers and sectors is not too wildly inaccurate, one expects to find that the benefits delivered by this kind of policy are high relative to its costs. And, as it happens, that is exactly what one does find.

### ***Consumer benefits***

The easiest benefit of competition to quantify is that arising from lower prices, and price fixing cases are the obvious place to start an evaluation of competition policy. The past decade has seen numerous cases brought by authorities around the world, and the numbers are large. The lysine case in the US was estimated to have done \$78m in harm to consumers, slightly less than the citric acid cartel (\$100m damages). The ready mix cartel in Germany generated damages of €112, the hydro-power electric case in Norway yielded damages of €140 and the hotel association cartel in Spain caused €180m in estimated harm.<sup>1</sup> Overcharges paid on vitamins imports during the vitamins cartel that lasted between 1989 and 1999 were estimated to be about \$72m per annum across nine countries where data could be gathered. To put this in perspective, the national budgets of the competition authorities in the various countries where these effects were felt sum up to about \$95m annually.<sup>2</sup>

More broadly – and moving beyond price fixing cases – in 2000 the Competition Commission in the UK found that new car prices were 10% too high, leading to a customer detriment of

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<sup>1</sup> See “Report on the Nature and Impact of Hard Core Cartels and Sanctions Against Cartel Laws Under National Competition Law”, OECD, April, 2002.

<sup>2</sup> See Julian L Clarke and Simon J Evenett, “The Deterrent Effects of National Anti-Cartel Laws: Evidence from the International Vitamins Cartel”, Working Paper 02-13, December 2002.

about £2b per year.<sup>3</sup> In 2003, the Commission found that the magnitude of excess pricing in extended warranties was between £116m and £152m per annum.<sup>4</sup> Similarly, in 2003 mobile phone operators were judged to have overcharged on termination of calls by up to 40%, and the remedy imposed was judged likely to result in gains to consumers of £325m–£700m in total over the 4 years during which it is in place. This is quite a return from the 12 months and £2.5m that the Competition Commission invested in this case (the subsequent Judicial Review cost a further £158k). And, to take one final example, the inquiry in to banking services provided to small and medium sized businesses found that the major clearing banks had over charged (through foregone interest payments) their customers by £525m per annum for the three years preceding the reference.<sup>5</sup> The remedy put in place was judged by three of the major clearing banks themselves to have cost them £373m in 2003 alone (the fourth didn't report a figure). The Commission spent £2.88m on this case.

Let me make three observations about these numbers.

First, it is important to put these benefits into their proper perspective, namely the cost to the public purse of the activities that delivered them to consumers. These four cases alone have generated savings to consumers of many multiples of the annual budget of the Competition Commission (which is around £25m), a number which, in turn, is much larger than the amount of money spent in each individual case. This is a decent return on money spent by any reckoning.

Second, it is worth being clear that I am not being selective in my citation of the evidence. Of course, not every case generates benefits on this scale, but that, as I remarked earlier, is not the point. Competition policy only swings into operation when really serious competition problems are thought to exist, and that means that it is in the nature of the policy that there will only ever be a few cases and, consequently, only a few big “winners”. And, as book publishers, music companies and film producers (to mention only three) know, it takes only one or two big winners to cover the running costs of the whole operation. The fact that not

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<sup>3</sup> “New cars: a report on the supply of new motor cars within the UK”, Cm 4660, April 2000. For discussions of this case, and other cases which attempt to quantify the benefits of competition, see Stephen Davies et al, “The Benefits from Competition: some illustrative UK cases”, DTI Economics Paper No 9, July 2004.

<sup>4</sup> “Extended warranties on domestic electrical goods: a report on the supply of extended warranties on domestic electrical goods within the UK”, Cm 6089 (1-111), December 2003.

<sup>5</sup> “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”, Cm 5319, March 2002.

every case generates benefits in excess of the costs of conducting the case is neither here nor there.

Third, and finally, these are only the consumer benefits of competition policy that we have been able to measure with any accuracy. There are many other cases where benefits to consumers have come which we have not been able to measure with any accuracy. In some cases, these are intangible benefits in the form of better service or a wider diversity of products, or benefits which come in the form of increased innovation whose ultimate consequences are very difficult to track down.

However, this said, it is also important to note that competition policy delivers benefits to firms themselves above and beyond the benefits – measured and unmeasured – that flow to consumers. Let me now turn to these.

### ***Benefits to producers***

Competition policy is about insuring that markets are, and remain, competitive. This brings benefits to consumers eventually in all of the ways that we discussed earlier. However, eliminating anti-competitive practices and dismantling monopoly positions that lead to abuses also benefit firms whose business suffers from these practices and abuses. A monopolist that raises prices to its consumers downstream has every incentive to try the same trick in reverse upstream, squeezing its suppliers as much as possible. A dominant firm that chooses to maintain a quiet life in its market may go out of its way to limit the actions of smaller rivals whose anxiety to get ahead is likely to disrupt its quiet life. All of these actions adversely affect consumers in the long run because they damage the process by which competition operates, but they also do more direct damage to the firms that feel their effects, and whose innovative activities are, as a consequence, unnecessarily restrained. If, as I am sure we all do, one feels that it is important to nurture the activities of small and/or entrepreneurial businesses, then the effects that competitive abuses have on other businesses are likely to be a concern.

As it happens, a great many of the cases that come to the Competition Commission involve intermediate, or business to business markets. The recent proposed merger between Stena and P&O concerned several Irish sea ferry routes used by haulier firms, many of which (and

those most likely to be adversely affected by the merger) are small, family owned businesses.<sup>6</sup> Most of the likely adverse effects of the many local newspaper mergers that we have investigated will be felt mainly by the small, local businesses that use these papers to advertise. On a somewhat larger scale, many of the suppliers adversely affected by the supermarket purchasing practices condemned in the 2000 Supermarkets inquiry (which spoke about a “climate of fear” created by such practices) are small entrepreneurial firms – farmers, small food processing firms and the like – and many of them are responsible for the innovative new products that we find on the shelves of our local supermarkets. Similarly, those affected by the practices of the major clearing banks uncovered during the 2002 inquiry into Banking Services for Small Firms were small and medium sized businesses. And, finally, the 2003 inquiry into Veterinary Medicines found effects arising from the way that medicines were dispensed that disadvantaged pharmacists.<sup>7</sup>

It is important to recognize that it is businesses large and small who are adversely affected by anti-competitive activity. Despite all the fuss about the quality of television on offer to viewers, the core of adverse finding in the recent merger between Carlton and Granada turned on the merger’s likely effects on a group of large, well established firms who rely on television advertising to reach out to their consumers. The inquiry also found likely adverse effects on the remaining ITV franchisees arising from the merger, but found no adverse effects on independent television producers. Similarly, one of the adverse consequences of the high termination charges set by mobile phone operators was a large transfer of profits from fixed line phone operators (including that well known small firm, BT). Since termination charges are passed through to callers, high termination charges set by mobile phone operators are perceived by users of fixed line phones as high fixed line charges – an interesting instance where a firm that raises its prices disadvantages its rivals!

No one seriously thinks that competition policy ought to provide a safe haven for small firms just because they are small, or that it ought to be used to promote entrepreneurship in some way or another. However, anti-competitive acts that harm other firms ultimately reduce their competitive initiative and their incentives to innovate. Quite apart from the adverse long run effects that it has on consumers, this is bound to reduce the basic vitality of businesses. If you are unsure of just what this might mean, talk to any of the smaller software producers

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<sup>6</sup> Stena AB and The Peninsular and Oriental Steam Navigation Company: a report on the proposed acquisition of certain assets relating to the supply of ferry services on the Irish Sea between Liverpool-Dublin and Fleetwood-Larne; ISBN 0-11-706500-5, February 2004.

<sup>7</sup> “Veterinary Medicines: a report on the supply within the United Kingdom of prescription-only veterinary medicines” (2 volumes), Cm 5781-I&II, April 2003.

(like Netscape) who have to live in the shadow of Microsoft, or any of those firms that it deals with in related businesses (such as Sun, the creator of Java). Competition policy was not designed to make life easier for these firms, but it was designed to prevent firms like Microsoft from making their life unnecessarily difficult.

### **Deterrence effects**

I have argued that competition policy typically delivers benefits to consumers that vastly outweigh the rather modest costs of running the competition policy regime in the UK. I have also argued that the benefits of an active competition policy go further, since firms also benefit from the relief that attacks against monopolistic abuses bring. All of this said, however, I think that there is a third source of benefits, and, although I do not know for sure, I think that this third source of benefits may deliver more than either of the two that I have already discussed. And, the charm of this third source benefits – called “deterrence effects” by economists – is that it is delivered by competition authorities even when they are inactive (so long as people think that they might become active).

At the back of every decision made by competition authorities – whether it be to prosecute a particular cartel, clear a particular merger or set prices in a particular regulated sector – is a line of reasoning. This line of reasoning, or argument, is, of course, specific to the particular case in hand, but it often has implications for the activities of firms in other sectors. Indeed, smart authorities write their decisions in particular cases with an eye to the broader applicability of their reasoning. And, firms contemplating a bit of price fixing or a particular merger, or deciding whether to appeal a licensing change proposed by their regulator to the Competition Commission, can – and do – use these past decisions to help guide their choices. This is, of course, competition policy in action, even if the authorities themselves are not actually acting. And, to the extent that firms desist from particular forms of conduct or particularly anti-competitive mergers without troubling the authorities, real resource savings are realized in both the private and the public sector.

One of the joys of deterrence effects – and I speak as a former professor of economics here – is that they are very hard to measure with any confidence. One of the few studies that tried to ascertain the impact of the simple existence of a competition authority on the price fixing behaviour of firms was that which I discussed earlier in connection with the international vitamins cartel. Comparing countries with and without an active competition enforcement regime suggested that prices were notably higher in the latter. The estimates suggest that the absence of the competition regime in the UK might have led to overcharging on the scale of a further \$30m per annum. There are two interesting things about this number: first, it is

about 50% larger than the actual over-charging that occurred in the UK (meaning that the deterrence effect is large in this case) and, second, it is about 65% of the total cost of the UK competition policy regime in 1999/2000. This is not a bad return on doing nothing more than existing!

Deterrence effects operate when cases set precedents that everyone understands and accepts. In the case of local radio station consolidation, the Commission's decision on the Galaxy-Vibe merger in the Bristol area has been widely interpreted as ruling out "thick" consolidation while leaving open the possibility that "thin" consolidation can bring together radio stations in different parts of the country provided that market shares do not get too large in any particular region.<sup>8</sup> It is impossible to know how many possible mergers that would have transgressed this rule did not happen, but most people in the sector believe that it is a number greater than zero. Deterrence effects also operate when firms begin to modify their behaviour during the course of a case, in anticipation of a finding. Although it is too early to say for sure what, if any, adverse effects of competition the current Store Cards inquiry will uncover, many people have noticed that some retailers (like IKEA) have begun to make large cuts to the APRs that they charge on their store cards, and some of the new store cards now being introduced have much lower APR's than many existing cards. This is not a bad payoff for an investigation which has only just started!

By way of digression, it is worth noting that substantial real resource savings can arise even during cases when parties come to us with a clear understanding of what the issues are, and what methodologies are going to be used to explore them. In this situation, the knowledge of the "rules of the game" enable the parties to focus on the arguments that really matter, and make their points economically and efficiently. The recent merger proposals concerning Safeway were conducted along ground rules which had been established in the larger Supermarket inquiry of 2000.<sup>9</sup> Those of you who have followed recent cases involving local newspaper mergers will have seen that they set precedents which are actively used by all of the parties in making their decisions. Much the same applies to recent rail/coach/bus mergers. And, finally, the Competition Commission's various investigations in the regulated sectors has established benchmarks or practices which are routinely used by both regulated firms and their regulators (for example, in the methods for calculating the cost of capital).

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<sup>8</sup> "Scottish Radio Holdings plc and GWR Group plc and Galaxy Radio Wales and the West Limited: a report on the merger situation", Cm 5811, May 2003.

<sup>9</sup> "Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc: a report on the mergers in contemplation", Cm 5950, September 2003.

Deterrence effects are basically about everyone knowing the rules of the game, and, when people who understand the rules are smart enough to discipline themselves to follow those rules, deterrence effects deliver. It is a test of effectiveness of any legal system – and of any selective and episodic competition regime that one might want to design – that it is, and should be, more or less self-policing. Indeed, my private lawyer friends tell me that they spend much more time telling their clients what we are likely to do in any given circumstance than they do in helping them to defend themselves in a case that has come before us.

Of course, not all of the issues or methodologies are clear cut in any particular case, and market conditions do change in a way which can make precedents less obviously germane even in the same market setting some years later. There is, therefore, often a good reason for a firm to elect to argue its case before the authorities. And when firms do this, there is no presumption that they have, somehow, failed to follow the rules. But, equally, one might say that this is exactly the kind of case that one wants to see investigated by competition authorities – a case where the established rules and procedures do not seem to apply or where circumstances have changed in an important way in a particular sector, and where, as a consequence, further guidance is needed.

### ***Conclusion***

The current challenge for those, like me, involved with competition policy is to make the system work. This means taking on the right cases, analyzing them properly, reaching the right decisions for the right reasons, explaining our reasoning, and doing so without a profligate expenditure of public money. When this happens, competition policy is worth it. And, as I have tried to show you this evening, the competition policy regime in the UK does deliver the three kinds of benefits that I have discussed today.

Let me close by emphasizing the two main points that I have tried to make today.

First, it is worth emphasizing that many of the benefits that come from the proper application of competition policy are felt in the first instance by firms. This is a point of some importance for those who seem to think of competition policy is just an added and unnecessary burden on business. Competition policy is sometimes a burden on business, but only on those businesses that try to unfairly disadvantage their rivals in ways that reduce their competitive abilities or incentives to compete vigorously.

Second, I believe that the benefits delivered by competition policy to consumers and firms alike add up to a large multiple of the costs that the public sector devotes to competition activity. This is certainly true if one confines attention to only that fraction of consumer benefits alone which can be measured with tolerable accuracy: our budget could be funded many times over out of the measured benefits generated for consumers by a few of our decisions over the past few years, and still leave substantial benefits left over for consumers. There may well be some people who do not regard this as value for money, but then again I am told that some people believe that Elvis is still alive and living happily in Southend-on-Sea.

Thank you.