The Evolving Role of Economics in Competition and Regulatory Cases.

Patrick Massey

Director

Compecon

Address to *16[TH] Annual Irish Conference*

Competition & Regulatory Law 2010

Thursday 7 October 2010,

Radisson Hotel,

Dublin.

1: Introduction.

Economics today plays a key role in competition and regulatory cases. The increased role and importance of economic analysis is one of the major changes that has taken place in competition policy over the past twenty years or so and economic thinking has significantly re-shaped competition law and policy in many jurisdictions. For example, legislation in many jurisdictions, including Ireland, treats cartels far more seriously than other forms of anti-competitive behaviour which is something that most economists would support. Economic thinking has changed the way competition law treats vertical restraints. The 1977 US Supreme Court judgment in *Sylvania* case, where the Court ruled that non-price vertical restraints were not *per se* anti-competitive is widely regarded as marking the coming of age of economics in US antitrust law.[1] Although it took another twenty years the EU has also adopted a policy toward vertical restraints that is consistent with economic theory. The 1984 US Department of Justice Merger Guidelines are regarded as the first attempt at establishing an economics based approach for analysing mergers and the concept of unilateral effects which tends to be the main focus in merger cases today, first appeared in the 1992 version of those Guidelines. Technological change has contributed to the growing importance of economics as it has resulted both in increased availability of data and enhanced the capacity of economists to analyse such data. The 1980s also saw a critical re-appraisal of how major public utility industries were regulated. At its core was a recognition of the key role of information and, in particular, the information asymmetry between the regulator and the regulated firm in the regulatory process.

The growing role and influence of economics in competition and regulatory cases, along with the increased sophistication of economic analysis, should, theoretically at least, have improved the quality of decision making and reduced the potential for errors. This has not proved to be uniformly the case. For example, while there has been a major re-appraisal of the likelihood of predatory pricing in the economics literature, such developments have had little influence on US jurisprudence. Some commentators have observed that the growing sophistication of analytical tools in merger analysis has coincided with a sharp decline in

[1] *Continental TV, Inc. et. al* v. *GTE Sylvania, Inc*., 433 US 36 1977.

merger enforcement in both the US and EU and a failure to block anti-competitive mergers. Here in Ireland there are serious questions about the quality of economic analysis in a number of key competition and regulatory cases.

2: Analysing Agreements.

Economic analysis tends to play little role in actual cartel cases. This largely reflects the fact that there is virtual unanimity among economists that cartels are always harmful and almost never efficiency enhancing. Economic views on the harmful effects of cartels would, however, appear to have influenced policymakers with the result that legislation in many jurisdictions including Ireland provides for more severe penalties for cartels than for other forms of anti-competitive behaviour. Indeed legislation in Ireland and a growing number of other countries provides that individuals responsible for cartel agreements may be imprisoned for such behaviour and most economists would support the view that imprisonment is an appropriate sanction for such behaviour.

Following the passage of the Competition Act, 2002, concerns were raised about the decision not to create a specific cartel offence in the legislation and to leave open the possibility for cartels to claim that they satisfied the requirements of section 4(5).[2] It was argued that this could greatly complicate the process of criminal prosecutions and require extensive economic evidence. Initially those concerns were not realised. That may have to be re-assessed in light last year's *Mayo Waste* case.[3] Prior to that case virtually all criminal cartel prosecutions had resulted in guilty pleas by the accused. A notable feature of the *Mayo* case was that defence counsel cross examined Authority witnesses about whether it had undertaken any economic analysis and about the possibility that the arrangements might have satisfied the requirements of section 4(5). In light of this economic evidence might feature prominently in future cartel prosecutions and it will be interesting to see how that plays out.

---

[2] See, for example, P. Massey and D. Daly, *Competition and Regulation in Ireland The Law and Economics,* Oak Tree Press, 2003.

[3] I should state here that I was retained as a possible rebuttal witness in this case by the Authority/DPP and there are obvious limits to what I can say regarding the case. I should also make it absolutely clear that nothing I say should in any sense be construed as questioning the outcome of the case.

Traditionally the EU Commission tended to treat all vertical restraints with suspicion. This largely reflected a legalistic approach and ignored the economic literature which indicated that most vertical restraints and certainly non-price restraints could not be regarded as automatically pro- or anti-competitive. Rather their effects depended on the circumstances of each specific case. Although this view had been accepted by the US Supreme Court in its 1977 judgment in *Sylvania*, the Commission clung to the view that all vertical restraints were in breach of Article 81(1) but satisfied the exemption requirements of Article 81(3) an approach. During the mid 1990s there was a considerable, sometimes heated, debate between the Commission and a number of national authorities who argued that the Commission's position was inconsistent with basic economic principles. Many external commentators were also highly critical of the Commission's approach. Eventually the pro economics arguments won out and the Commission revised its treatment of vertical restraints, albeit almost twenty years after this change had occurred in the US.

The economic literature indicates that vertical restraints are likely to give rise to competition concerns where:

1. Firms enjoy some degree of market power;
2. Inter-brand competition is weak; and
3. There is little evidence that the arrangements are efficiency enhancing.

In the Irish cylinder LPG market the two main suppliers account for more than 90% of the market. The Competition Authority has stated that inter-brand competition in this market was weak and also found little evidence that exclusive dealing agreements were efficiency enhancing. It also reported strong similarity in price changes by the two largest suppliers. In other words the circumstances prevailing in this market are those in which, according to the economics literature, exclusive dealing agreements are likely to be anti-competitive. Despite this the Authority issued a Declaration permitting such agreements provided they were limited to two years in duration. The Authority had failed to advance any clear economic justification for this decision which is so fundamentally at odds with the economic literature. At the time of the Declaration it argued that when such agreements had previously been limited to two years, smaller suppliers had increased their aggregate market shares to around 7% but this had fallen back to around 2% with the re-introduction of five year exclusive agreements by the big two suppliers.

At the time of the Declaration the Authority left open the possibility that it would review the market after five years but announced recently that it considered there was no need for a review. It gave no indication at that time whether small firms have gained market share in recent years or if there was any evidence of any increase in inter-brand competition.

3: Abuse of Dominance.

Having revised its approach to vertical restraints in the late 1990s, the Commission turned its attention to developing a "more economics based approach" to abuse of dominance. In contrast to the traditional approach of the Commission which was criticised for concentrating on protecting competitors rather than protecting competition, this new approach has centred on the concept of consumer harm. Many economists argued that, particularly, in cases of alleged abuse of dominance, it should be a requirement to demonstrate that the behaviour in question harmed consumers.

> "In the limit, the idea that there could be harms to the competitive process, justifying competition policy intervention, that are not even capable of harming consumers is unattractive. Competition to serve the needs of the general public of consumers – not some abstract notion of competition for its own sake – is the point of competition policy."[4]

From an economics perspective, therefore, the ruling by the Supreme Court in the Irish League of Credit Unions case, that consumer welfare is the sole objective of competition law is highly significant.

> "The entire aim and object of competition law is consumer welfare. Competitive markets must serve the consumer. That is their sole purpose. Competition law, as is

[4] J. S. Vickers, Abuse of Market Power, *Economic Journal*, 115, 2005. See also P. Gorecki, Form Versus Effects-Based Approaches to the Abuse of a Dominant Position The Case of Ticketmaster Ireland, *Journal of Competition Law & Economics*, 2(3), 2006.

> often said, is about protecting competition, not competitors, even if it is competitors who most frequently invoke it."

The ILCU case is the only abuse of dominance case which the Competition Authority has brought to court in 14 years. The Supreme Court was highly critical of the Authority's economic analysis in that case.

> "It is not altogether surprising that the Authority has failed to provide a convincing analysis of ILCU's activities as being anti-competitive. The history shows that it has changed its position in relation to ILCU on several occasions. It was permitted finally to change its stance from that advanced in the statement of claim only because Mr. Collins decided not to object, believing this radical change of position, demonstrated the lack of credibility in the Authority's case. It certainly seems to me to undermine confidence in the Authority's consistency."

This highlights the need to formulate a coherent economic theory of competitive harm in abuse of dominance cases.

It is often suggested that the US Courts have been more willing to take on board new economic thinking than their EU Counterparts. Predatory pricing is a notable exception. Up to the 1980s a number of leading US economists largely associated with the University of Chicago had argued that predation was simply not a rational strategy for a dominant firm and therefore allegations of predatory behaviour should be dismissed. However, such arguments were based on the twin assumptions of perfect certainty and perfect information on the part of all market participants and relaxing such assumptions led to very different conclusions. An extensive economic literature has developed over the past 25 years or so which demonstrates that predation may constitute a rational and effective strategy for a dominant firm.[5] This literature has had virtually no impact on US courts which have continued to rely on outdated economic theories.

---

[5] P. Bolton, J.F. Brodley and M. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 1999.

The concept of joint dominance first emerged from EU Commission merger decisions. However, it has been suggested that firms that engage in tacit collusion should be considered to be jointly dominant. The European Court of Justice has held that the same criteria can be used to establish joint dominance in both mergers and Article 102 cases. This approach seems incorrect from an economics perspective. Merger control is structural, thus arguably if post merger market conditions are likely to be more favourable to tacit collusion that would be sufficient to justify prohibiting a merger. However, Article 102 is concerned with behaviour and establishing that market conditions favour tacit collusion is not sufficient to establish that firms have actually engaged in tacit collusion.[6]

4: Mergers

The 1984 US Department of Justice Merger Guidelines represented the first serious attempt to set out a clear economics based approach to merger analysis. The Guidelines, however, only addressed the issue of co-ordinated effects which were seen as the main concern at that time. The concept of unilateral effects was only introduced in the 1992 version of the Guidelines. Its introduction reflected theoretical developments in the analysis of oligopolistic markets which showed that firms could raise prices unilaterally even if they were not dominant. The analysis of unilateral effects led to a debate about the relative merits of the dominance versus the substantial lessening of competition (SLC) test in merger cases with the SLC test generally favoured by economists because the dominance test only caught a subset of unilateral effects cases. The Competition Act, 2002, incorporated the SLC test and the UK also opted for this standard at around the same time. The EU subsequently moved to the SLC standard although for some reason they decided to call it the SIEC test. Quantitative analytical tools for predicting the likelihood of unilateral effects have been well developed and are widely applied in many jurisdictions.

Several authors have questioned the fact that the move to a more economics based approach to merger control has resulted in a sharp decline in merger enforcement in both the US and EU. It is estimated that roughly 50% of merger challenges brought by US enforcement

[6] This issue is discussed in more detail in P. Massey and M. McDowell, Joint Dominance and Tacit Collusion: Some Implications for Competition and Regulatory Policy, *European Competition Journal,* 6(2) August 2010.

agencies between 1994 and 2009 were unsuccessful.[7] It is argued that this is due partly to the fact that the development of more sophisticate analytical tools has shifted the standard of proof in merger cases away from the balance of probabilities standard. Increased reliance on numerical analysis has resulted in US Courts placing little weight on documentary or customer evidence. It is also suggested that documents demonstrating anti-competitive intent have lost most of their probative force.

Similarly it is suggested that in the EU over the 2004-2008 period "horizontal merger enforcement seems to have ground to a near halt".[8] In a number of cases the Commission cleared mergers without conditions having initially raised strong objections only to perform a "spectacular U-turn".[9] This decline in EU merger enforcement is harder to explain.

In contrast the analysis of coordinated effects is far less well developed. The literature has identified certain market characteristics which are known to facilitate coordinated behaviour but the fact that a market displays such characteristics does not establish that firms would actually engage in coordinated behaviour.

The EU originally developed the concept of joint dominance to address the issue of coordinated effects. The concept first emerged in the 1993 *Nestle/Perrier* case. The Commission found that a reduction in the number of firms from three to two would facilitate potential collusion. It required the merging firms to divest a number of brands to the third firm in the market. Ironically it has since been suggested that the divestiture imposed by the Commission actually increased the likelihood for collusion post-merger. It is also suggested that one of the reasons why the Commission opted for divestiture rather than an outright

---

[7] O. Budzinski, An Institutional Analysis of the Enforcement Problem in Merger Control, *European Competition Journal* 6(2), August 2010. Note in the US the competition agencies do not have power to prohibit mergers but must challenge alleged anti-competitive mergers before the courts.

[8] F. Maier-Rigaud and K. Parplies, EU Merger Control Five Years After the Introduction of the SIEC Test: What Explains the Drop in Enforcement Activity, *European Competition Law Review*, 30, 2009.

[9] Budzinski, p.449.

prohibition was because it was concerned that it might lose any appeal as the Merger Regulation contained no reference to joint dominance.[10]

The Commission subsequently suffered a major reverse when it sought to expand the concept of joint dominance to a four to three merger in *Airtours*. The then Court of First Instance was highly critical of the Commission's economic analysis in that case and found that the market did not display the necessary conditions for coordinated behaviour post-merger. Following two further reversals in merger cases, the Commission instituted a number of internal reforms including the establishment of the position of Chief Economist whose role *inter alia* is to independently review the Commission's analysis in complex merger cases.

Out of 420 merges notified to the Competition Authority up to the end of 2009, approximately only 20 required a detailed economic analysis. In a limited number of those cases, the Authority's economic analysis is open to serious question.

Coillte/Weyerhaeuser was a vertical merger which was cleared by the Authority. Some of the arguments for approving the transaction were highly unsatisfactory from an economics point of view. The Authority accepted that the merger could enable *Coillte* to abuse a dominant position. It argued, however, the IFA would be able to lobby the Government to secure a remedy for any anti-competitive harm. This is simply not a valid basis on which to approve a merger from an economics perspective. The case arguably creates a very dangerous precedent.

Unilateral effects issues mainly arise in the case of differentiated products and most consumer goods are regarded as differentiated products. According to the standard models which underpin unilateral effects analysis the issue of whether or not a merger would permit the merged entity to unilaterally raise prices depends on the relative closeness of the merging

[10] O. Compte, F. Jenny and P. Rey, Capacity Constraints, Mergers and Collusion, *European Economic Review*, 46(1) 2002.

products. Pre-merger the individual firms cannot raise prices unilaterally because profits lost due to lower sales volumes will more than offset any profits gained from selling a smaller quantity at the higher price. Following a merger some of the sales lost as a result of a price increase will go to the other merging brand. Thus the total volume of sales lost to the firm is less than it was before the merger and a unilateral price increase which was previously unprofitable may now be profitable.

Establishing that merging brands are close substitutes is only the first step in the analysis. It is essential to take into account the likely responses of various other players before one can conclude that a merger would result in a unilateral price increase. In particular it is necessary to consider:

- The potential for other suppliers to reposition their brands to make them closer substitutes for the merging brands so that they will exercise a greater competitive constraint on the merging brands post merger.
- The potential for new entry and/or expansion by existing competitors; and
- The potential for buyers to exercise countervailing buyer power.

It is clear from the literature, from international best practice and from the Competition Authority's own guidelines that brand repositioning by other suppliers post merger may prevent any unilateral price increase. The Authority failed to consider this in its *Kerry/Breeo* decision.

The Authority Merger Guidelines recognise that the scope for any unilateral price increase may be constrained by new entry but require such entry to be:

- Sufficient;
- Likely: and
- Timely.

In *Heineken/Scottish & Newcastle* the Authority argued that a planned increase in capacity by *Diageo* the other remaining brewer in the market would prevent any unilateral price increase. The *Diageo* plan certainly met the sufficiency test but it is not clear that it met either the timely or likely tests. The new plant was originally not due to come on stream until 2013, five years after the merger. According to the Authority to be considered timely entry must occur within two years. It is difficult to see any economic justification for applying a five year time frame in this instance. The proposal has since been put on hold by *Diageo* raising questions under the likely heading. The two are to some extent interrelated as a project which is not due for completion until five years down the road is obviously subject to a greater degree of uncertainty than one which is expected to be completed in two years.

It is also necessary to consider whether customers would be able to exercise countervailing buyer power to defeat any unilateral price increase. To exercise countervailing buyer power, customers must normally be large buyers, although large size on its own is not sufficient. The buyer must be able to do without the product, at least for a period of time.

The Authority in *Heineken/S&N* also argued that any unilateral price increase would be prevented because individual pubs would be able to exercise countervailing buyer power by de-listing a brewer's weaker brands. The decision offers no analysis to support such a conclusion. Individual pubs are small undertakings when compared with the brewers, which immediately begs a question about their ability to exercise buyer power. The obvious question is, if they were to de-list a less popular brand, what would they replace it with, a question which the decision did not address at all.

At roughly the same time, the Authority concluded that the main supermarket multiples would not be able to exercise countervailing buyer power. In this instance the Authority argued that in order to do so the multiples would have to finds alternative brands which customers would be prepared to buy. The Authority in this instance took the view that to exercise countervailing buyer power the retailers must be able to permanently replace the merging brands with supplies from another source. This view is not supported by the economic literature which indicates that firms can exercise countervailing buyer power by delaying or deferring orders. Provided the retailers can reduce or defer orders sufficiently to render the price increase unprofitable they can exercise countervailing buyer power.

It is also recognised that prices will not increase post-merger if the merger yields sufficient cost savings in the form of efficiencies. The Competition Authority has only considered the question of efficiencies in one merger case. The Authority initially argued that the parties' efficiency claims were likely to be exaggerated because the social costs and benefits probably exceeded the cost and benefits to the merging parties. In determining whether or not efficiencies will prevent any price increase, what matters is the merged firm's cost savings not what happens to social costs. The Authority's decision seeks to pass off its earlier references to "social costs" as "an infelicitous use of language". In its decision it claims that the parties' estimates of cost savings might be exaggerated because the price paid by one of the firms, which had outsourced its production to third parties, might include a contribution to its suppliers' fixed costs whereas only variable cost savings should be taken into account. The variable cost to *Breeo* was the price it paid to its suppliers, the argument that this price might have included a contribution to the latter's fixed costs is simply irrelevant. The Authority also argued that even if the efficiencies claimed by the parties were realised they would be insufficient on the basis that they amounted to approximately only 1% of total market sales of the relevant products. This argument makes no sense.

There are serious problems with the Authority's economic analysis in these cases.[11] As in the case of the European Commission, procedures need to be put in place to address such issues. The Authority retains outside economists to advise on difficult merger cases. The role of such outside experts should be to independently review the Authority's analysis. It might also be an opportune time for the Authority to institute some form of consultative process with outside economists to see if it is possible to resolve some of the issues that have emerged.

---

[11] For a more detailed discussion see P. Massey, Taking Politics Out of Mergers: A Review of Irish Experience, *Journal of Competition Law & Economics*, 2010.

The appeal process in merger cases limits the potential for the Court to hear witness evidence. Again this is something that needs to be revisited. If the Authority had to introduce witness evidence in support of its findings this would provide the parties with a right to subject them to close questioning and this could greatly assist the Court in such appeals.

5: Market Definition.

Market definition has traditionally been regarded as the starting point in competition cases, particularly in abuse of dominance and merger cases. Yet traditionally it was an issue which received little attention from economists. Thus in 1982, George Stigler wrote:

> "My lament is that this battle on market definition...has received virtually no attention from us economists."[12]

The 1984 US Merger Guidelines led to increased attention on market definition and resulted in the development of the famous SSNIP test which is now widely accepted throughout the World. Irish courts initially had difficulty coming to terms with quantitative tests for market definition and in a number of early cases tended to fall back on subjective tests.

Just when we had all come to terms with the famous SSNIP test the US authorities have recently revised their Horizontal Merger Guidelines dropping the requirement to define a relevant market and adopting an approach that seeks to measure unilateral effects directly using merger simulations A number of economists have advocated such an approach.[13] It has, however, proved somewhat controversial with DG Comp's Chief Economist expressing serious reservations.[14] If one dispenses with the need to define the relevant market then there is no simple screening mechanism such as levels of market concentration which can be sued

[12] G. Stigler, The Economists and the Problem of Monopoly, *American Economic Review,* 72, 1982.

[13] See, for example, J. Baker and C. Shapiro, Reinvigorating Horizontal Merger Enforcement that has Declined as a Result of Conservative Chicago Analysis, in R. Pitofsky, ed. *Where the Chicago School Overshot the Mark,* Oxford University Press, 2008 and G. J. Werden, Next Steps in the Evolution of Antitrust Law: What to Expect from the Roberts Court, *Journal of Competition Law & Economics*, 5(1), 2009.

[14] See, for example, D. Neven, *First Impressions on the Revised US and UK Merger Guidelines,* Address to Global Competition Review Conference, Brussels, 29th September 2010.

to distinguish innocuous cases from potentially problematic ones.[15] Simulation models also suffer from a number of limitations which are widely recognised in the literature. In particular they are static models which do not take account of a whole variety of factors such as potential brand repositioning by rivals, new entry and countervailing buyer power. Simulations which are based on Nash Bertrand models of differentiated product markets predict price increases for all horizontal merges no matter how fragmented the market in the absence of sufficient offsetting efficiencies. It is difficult to see how one could analyse the potential for brand repositioning and entry if the relevant market has not been defined.

6: Regulation.

When it comes to monopoly regulation, economic analysis indicates that:

- Where competition is possible, it is likely to be superior to regulation; and
- Where regulation is necessary the objective of the regulator is quite simple, at least theoretically, it is to try and bring about the competitive market outcome. In other words the regulator should attempt to prevent the regulated monopoly from setting output and prices at the monopoly level and instead set them at the level that would prevail if the market were competitive. In fairness to regulators that is a big ask.

The past two decades have seen a major re-evaluation of regulatory policy in jurisdictions throughout the world. Based on this analysis the EU Commission has introduced various measures to liberalise many public utility industries including electricity, gas and communications. In the latter case the regulatory framework introduced in July 2003 limited the scope for regulatory intervention by national regulatory authorities to those markets where there was a genuine absence of competition.

While the economic literature warns of the dangers of regulatory capture it is not clear that this has received sufficient attention in Ireland. For example, the ability of officials engaged

[15] J.J. Simons and M.B. Coate, Upward Pressure on Price Analysis: Issues and Implications for Merger Policy, *European Competition Journal,* 6(2), August 2010.

in financial regulation to move seamlessly to new posts in the institutions which they previously regulated has been commented on. There is also the Irish regulator who wrote to the regulated firm and asked it to prepare a paper on how it should be regulated which the regulator then published and invited comments on.

The CER has indicated its intention to remove regulatory controls on pricing in the household electricity market once the ESB's market share dips below 60% and there are at least two other suppliers with market shares of at least 10%. The economics literature indicates that competition where possible is superior to regulation and decisions by regulators to step back from active regulation are generally to be welcomed not least because of their novelty. At the same time it seems reasonable to ask whether such a market structure could be considered sufficiently competitive as to remove the need for regulation.

Consider how firms in a competitive market would respond to a fall in demand. In the short-run they would could prices although in the longer run they might also attempt to reduce output and capacity. Firms in a competitive market would clearly not respond to a fall in demand by raising price in an attempt to maintain revenues. The Aviation Regulator decided in 2009 that the DAA should be permitted to raise its charges to compensate for a projected decline in passenger numbers. Firms in competitive markets would not have responded in this way as is clearly evidenced by the reaction of the airlines which began cutting fares. Indeed the regulator seems to have recognised this as he indicated that the increase in airport charges would not lead to higher ticket charges for passengers. In a contracting market the airlines would have no option but to accept a further squeeze on their margins at a time when the international economic downturn was putting them under severe pressure.

6: Conclusions

Economics has assumed an increasingly important role in competition and regulatory cases. This represents a welcome development as economic analysis provides a useful framework for analysing the effects of various company practices and for ensuring that competition and regulation maximise consumer welfare. The outcome has not always matched expectations.

In the US, for examples, it has become virtually impossible to bring a successful case for predation largely because of the courts adherence to outdated economic theories. Improved economic analysis of merger cases has perversely resulted in less effective merger enforcement on both sides of the Atlantic.

In Ireland there are serious questions about the quality of economic analysis in a number of important competition and regulatory cases. Much of the time regulatory agencies in Ireland tend to operate below the radar and much of what they do, both good and bad, goes unremarked outside of a small specialist audience. We have learned in the case of financial regulation that a failure to ensure that regulators are doing their job properly can prove very costly.