Market Power and Dominance.

> "To confer a monopoly upon a producer is to give them the power of levying any amount of taxation on the public for their individual benefit, which will not make the public forego the use of the commodity." (John Stuart Mill, Principles of Political Economy, 1848).

Introduction.

Dominance is essentially a legal rather than an economic concept. Economists focus on the issue of market power rather than dominance. While there are obvious links between the two concepts they are somewhat different. There is no presumption in any part of the Competition Acts, or the EU Treaty, that mere size, or even possession of a dominant position, is offensive or problematical in itself. The concern is with conduct and behaviour.

The Meaning of Market Power.

In economic terms market power is defined as power over price. In oligopoly markets with differentiated products all firms have some degree of market power, but not enough to be considered dominant. In differentiated product markets the firm's demand curve is downward sloping. This means that, if the firm unilaterally increases its prices, it will lose some but, crucially, not all of its sales. This gives it some power over price. Many real world firms therefore have some market power and at the same time face competition from rivals.

Products may be regarded as differentiated if consumers perceive them to be different or, put another way, consumers do not regard them as perfect substitutes for one another. Brand image is one source of such differentiation.

Dominance.

To be regarded as dominant in an economic sense, a firm, or group of firms, must have sufficient market power to enable it to raise price or act in some other way independently of its rivals. This reduces to a question of whether a unilateral price increase would be profitable. The answer to that question depends on the steepness of the slope of the firm's demand curve, known as the firm's residual elasticity of demand. The residual demand curve is the demand curve faced by an individual firm. It is the total market demand curve less the supply of all the other firms in the market at each price. If the firm has a relatively inelastic residual demand curve, then a price increase will result in a relatively small decline in sales and it will be profitable for it to raise prices unilaterally. A relatively elastic residual demand curve means that a small increase in price would result in a substantial drop in sales making a unilateral price increase unprofitable.

The European Court of Justice recognised that a firm could not be considered dominant unless it could set its prices independently of its rivals.

> "..the fact that an undertaking is compelled by the pressure of its competitors' price reductions to lower its own prices is in general incompatible with that independent conduct which is the hallmark of a dominant position". (*Hoffman LaRoche v. Commission* [1979] ECR 461 at para 71).

Competition on the Fringe.

A dominant firm may face competition from other firms. As a general rule, however, the dominant firm will typically be much larger than its rivals. These smaller firms could achieve large increases in profitability by competing aggressively with the dominant firm. However, they face the threat of an overwhelming reaction by the dominant firm, which can act as a significant deterrent. Thus, rather than challenging the dominant firm across the board, smaller firms are likely to confine their activities to specialist niches, thereby not posing a major threat to the dominant firm. In the literature smaller firms in such circumstances are referred to as a 'competitive fringe'.

The dominant firm may effectively be able to ignore the actions of its competitors and influence market prices by varying its output. It can, by exercising its market power, harm consumers and competitors.

Sources of Dominance.

A firm may be dominant for a variety of reasons. It may be more efficient than rival firms, it may have grown larger as a result of economies of scale or its products may be regarded as superior to that of its competitors. Advertising to establish brand image is one means by which firms attempt to differentiate products thereby increasing the slope of their demand curve.

Measuring Market Power.

Lerner proposed that the degree of market power should be defined as:

$$(p-c)/p$$

where p is price and c represents short-run marginal cost. (A. Lerner, (1934), The Concept of Monopoly and the Measurement of Market Power, Review of Economics and Statistics, Vol.1, 157-75). The Lerner Index essentially is the left-hand side of the profit maximisation condition for a monopolist, which is normally expressed as:

$$(p-c)/p = 1/e$$

where e is the elasticity of demand. This can easily be modified to the case of a dominant firm where e is defined as the residual elasticity of demand of the dominant firm. The Lerner index is the inverse of the residual elasticity of demand which can therefore be used to estimate market power. It has become common in US cases for economists to estimate residual elasticities of demand and these have been accepted by US courts. The US Supreme Court has expressed the view that: "[w]hat constrains [a] defendant's ability to raise prices…is the elasticity of demand faced by the defendant – the degree to which its sales fall…as its price rises." (*Eastman Kodak v. Image Technical Servs., Inc.*, 540 US 451, 469, (1992)).

Market Share and Dominance.

While a large market share may, in some circumstances, indicate that a firm has a dominant position, of itself, market share is neither a necessary nor a sufficient condition to establish dominance. In *Akzo* [1991 ECR I 3359] the Court of Justice considered that a stable market share of 50 per cent or more raised a rebuttable presumption, although it added that the Commission was right to consider other factors. It is not only a firm's absolute size or market share that matters in terms of establishing dominance but its size relative to its competitors.

Studies have shown that a dominant firm's market share may decline over time. However, such declines generally occur gradually and there are numerous examples of dominant positions continuing for decades. This is because a dominant firm will normally be able to take measures to prevent the erosion of its market share.