Local Food, Sectoral Reform and Applying Competition Law to Business

Director's Letter
Catherine Waddams

This edition reflects the varied and topical research undertaken at the Centre on competition issues and sectoral regulation, and the involvement of all levels of academics and disciplines, across several Schools, in the Centre's work. Andrew Bugg reports on the demand for locally sourced food at British supermarkets, and implications for future changes in shopping habits – particularly topical at a time when the supermarket sector is under such intense public scrutiny. Khac Pham reviews the reforms in the Vietnamese insurance industry, bringing his own experience of regulating the industry to his work and suggesting that more relaxation of regulation might benefit the industry further. The reform theme is taken up in Liz Hooper and Andrei Medvedev's article on the electricity sector in South East Europe. Liz and Andrei are contributors to a project for which visitors from the region have visited the Centre to present and discuss their papers on reform in their particular country. The work will culminate in a workshop in Romania in July.

Issues of the marketing function within businesses and its role in competition problems are discussed by John Ashton and Andrew Pressey's article on market inquiries of the UK Competition Commission and its predecessors. Bruce Lyons addresses the application of Article 82 to businesses, examining whether it should be enforced to prevent exploitation of customers, as well as its more usual use to curb exclusion or constraint of competitors. Bruce's emphasis on the political dimension of competition decisions links well with the Centre's growing involvement of political science in its research, a strand which will be considerably strengthened by the appointment of the Centre's political science mentor, Hussein Kassim, to a chair in UEA's School of Political, Social and International Studies. We look forward to links with his new School to broaden and strengthen CCP's research. We are also pleased to welcome two other new members to the Centre. Daniel Zizzo is a Senior Lecturer within the School of Economics and will bring expertise in experimental and behavioural economics. Andrew Pressey is a Lecturer from Norwich Business School and will be working with John Ashton, investigating firms' perceptions of competition authority decisions and compliance with UK competition law.

The integration of political science is illustrated by the programme for our third annual conference on Comparative Perspectives on Multi-Jurisdictional Antitrust Enforcement. In the same week we will hold our third PhD workshop, at which invited visiting students and resident CCP students will present their work.

In January CCP hosted the Network of Industrial Economists' conference, with "Tacit Collusion and Firm Asymmetries" (Prof Steve Davies and Matt Olczak) and "How (Not) to Measure Competition" (Prof Jan Boone) amongst the papers presented. As well as our visitors from South East Europe for the Project 5 seminars we have been delighted to welcome Kati Ceres, Assistant Professor of Law at the University of Amsterdam, for a longer visit to stimulate our own research ideas and explore issues of common interest.

CCP Summer Conference:
Comparative Perspectives on Multi-jurisdictional Antitrust Enforcement
14 – 15 June 2007
UEA

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Supermarket Sourcing from your neck of the woods: Some Experimental Evidence and Implications for the Grocery Sector

Andrew D. Bugg

Local food has become an interesting talking point in recent years. Both the government and media have sought to improve the diets of the general public and revive a damaged agricultural sector after years of falling consumer confidence. Local food is seen as having an important contributory role in achieving these aims. In this article, experimental evidence is presented which suggests that there is consumer demand for local food sold at supermarkets.

The Experiment

Supermarket consumer choice behaviour was investigated by exploiting an occasional marketing activity sometimes used by supermarkets, where farmers are invited to take part in an in-store farmers’ market. An economic experiment was conducted, where supermarket consumers were asked to make a series of hypothetical choices between alternative fresh food items of the same type (fresh vegetables). All items had the same attributes which were allowed to vary in quality level. The attributes and their respective quality levels (in parentheses) were as follows: price (£0.80, £0.90, £1.00, £1.10 and £1.40), origin (Norfolk, East Anglia other than Norfolk, British and imported), freshness (today as opposed to yesterday), traceability (awareness of the producer and production methods) and a reduced use of packaging, above that of a British alternative typically found on supermarket shelves. As a result, supermarkets may increasingly jump on the local food ‘bandwagon’ led by the recent growth in the number of farmers’ markets. An increase in the volume and variety of local food sold in supermarkets could have the impact of reducing the market shares of independent grocery retailers. As a result, we may observe a decline in their market presence which would be damaging for competition in this sector.

The Results

Figures 1 summarises the main results. The influence of quality levels on choice is measured as the average supermarket consumer’s willingness to pay (WTP) for a quality level compared to the base quality level for each attribute. The base quality level was set as typical supermarket quality levels (British, fresh yesterday, no opportunity to meet the producer at the point of sale, packaged and priced at £0.90). Figure 1 shows the implied willingness to pay for an average supermarket consumer for all attribute quality levels.

We can see that freshness is important. As expected, the fresher the better, or the higher the WTP. The second interesting result is the positive and significant WTP for the opportunity to meet the producer at the point of sale. This attribute, in this context, reflects product traceability, albeit by proxy. In other words, do consumers want information made available regarding the reputation of the producer and the production methods used? The evidence suggests yes. For supermarkets, unlike farmers’ markets where the producer is always present at the point of sale, this poses an important question as to how the gap between producer and consumer can be breached. Tied into this, the use of packaging appears to be unimportant in influencing choice. Therefore, packaging can be used with no real effect on demand. If supermarkets want to create a link between the producer and the consumer, then packaging is this potential link. To date, supermarkets are using it to bridge the gap.

There is little difference between the implied willingness to pay for Norfolk and East Anglia over that of a British alternative. Comparing this with the results of Bugg (2007), supermarket consumers are much less ‘origin specific’ compared to farmers’ market consumers. What this suggests is that supermarkets can be more flexible with their definition of local food compared to farmers’ markets. Farmers’ markets are restrictive in their definition of local food, to protect the interest of producers. For supermarkets this finding is important as it will assist with the efficiency of sourcing given a wider area from which to select producers.

Implications for the Grocery Sector

To conclude, the fact that there is demand for local food at supermarkets presents a worrying projection for other grocery retailers, such as independent greengrocers, farm shops and farmers’ markets. Supermarkets through economies of scale in procurement have a competitive advantage over such retailers, as well documented by the Competition Commission (CC, 2000). In further work, Bugg (2007) suggests that if consumers dedicate a fixed period of time to do their food shopping per week, as is typical, then the further they have to travel to shop at a supermarket, the less likely they are to shop at a farmers’ market to ‘top-up’ their grocery shopping. As such, in an age of ‘one-stop’ shopping, local food procurement by supermarkets may well have a damaging effect on other forms of grocery retailing, reducing their market shares. The knock on effect could be the closure of many outlets through which producers can sell their produce. However, if supermarkets do decide to take a giant step and source increasingly from the local food sector they must be aware of the issues that lie ahead such as enforcing fair contractual obligations regarding codes of conduct for producers.

* The author would like to thank Bruce Lyons, Christopher Wilson and Matthew Olczak for comments on the full version of this work.

1 Local food is classically defined as food originating from within a given radius of its eventual point of sale (typically 30 miles). The past decade has seen the outbreak of Bovine Spongiform Encephalopathy (BSE) and more recently Foot and Mouth Disease (FMD). This research was originally motivated by the latter through the findings of the Policy Commission for the Future of Farming and Food in England which set out the importance of localising food markets. The World Health Organisation recently highlighted evidence that the consumption of foods with low nutritional content is responsible for diseases such as diabetes, heart disease and some cancers. As a result government policy has increasingly become nutrition driven. (WHO/FAD, 2003). Diet, Nutrition and the Prevention of Chronic Diseases, WHO Technical Report 916, Geneva.)

* The author would like to thank Bruce Lyons, Christopher Wilson and Matthew Olczak for comments on the full version of this work.

2 In-store farmers’ markets are rare events, but are used by supermarkets to promote local food and assist local producers.


4 * refers to 5% significance or better. Implied WTP is estimated utilising the conditional logit framework.

Mixed Results from Reforming Vietnam’s Insurance Industry

Khac Pham

After over 10 years of negotiations, on 11th January 2007, Vietnam became the World Trade Organisation (WTO)’s 150th member. The WTO entry implies an increase in competition in Vietnam’s financial market in general and the insurance industry in particular. This article briefly examines the level of competition that has existed within the insurance industry and implications for improving competitive conditions once it has attained membership in the WTO.

Many structural changes in the Vietnamese insurance industry can be attributed to deregulation. However, the question whether recent deregulation has improved efficiency and productivity of the Vietnamese insurance industry is much of interest. By focusing on the period 1998-2004 where all the major changes in the Vietnamese insurance industry occurred (Table 1), recent research by the author has revealed some interesting findings. On the one hand, the non-life insurance market revealed that there was an improvement in its technical efficiency with the average increase of 2.7% per annum. However, its total factor productivity seems to have regressed by 5% per annum. This was mainly due to an inward shift in the production frontier. On the other hand, there was an impressive productivity growth at 43% per annum in the life insurance market. This was due to both improvement in technical efficiency and technological progress. Furthermore, it is observed that ownership and competitive environment had a significant impact on technical efficiency. The larger insurers are more likely to appear efficient than the smaller insurers. Overall, the findings suggest that insurers have benefited from the deregulation.

Table 1: Summary of the deregulation process of the Vietnamese insurance industry (1993-2005)

<table>
<thead>
<tr>
<th>Changes</th>
<th>1993</th>
<th>1995</th>
<th>1998</th>
<th>2001</th>
<th>2003/05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reforming regulatory institutions</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Designing markets and regulation</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowing new insurers to enter market</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Diversifying ownership of insurers</td>
<td>X</td>
<td></td>
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</tr>
</tbody>
</table>

An insight into the industry would provide some explanation for the above empirical findings. Vietnam had a mono-insurance system until 1994. The one state-owned insurance firm combined the roles of regulatory responsibility and commercial insurance. The whole insurance industry was operated in accordance with the production plans laid down by Government. Competition among firms emerged in 1999 when significant structural changes were taken in the insurance industry. It has mainly evolved from a mono-insurance system to a more diversified one that includes 4 state-owned, 8 joint-stock, 5 foreign joint-venture and 10 wholly foreign-owned firms in 2005. Have the structural changes made the insurance industry more competitive?

Since the restructuring, Vietnam’s insurance market has been growing at a fast rate of 20% per year. Despite the impressive growth, the insurance market is still in its infancy because of the limited number of products available, inexperienced management and low insurance awareness by the public. As shown in Figure 1, which displays the growth of insurance penetration during the period 1994-2004, the insurance industry is still only a small part of Vietnam’s economy, accounting for 2% of GDP.

In terms of gross premiums written, there was a reasonable decrease in overall concentration ratios (Table 2). The largest firms are the state-owned firms that have taken up the majority of general and life insurance premiums with two-firm concentration ratios decreasing from 76.78% and 90.79% respectively in 2000, to 60% and 79% respectively in 2005.

Table 2: Two-Firm Concentration Ratios (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>General insurance</th>
<th>Life insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>76.78</td>
<td>90.79</td>
</tr>
<tr>
<td>2003</td>
<td>65.25</td>
<td>80.44</td>
</tr>
<tr>
<td>2005</td>
<td>60.00</td>
<td>79.00</td>
</tr>
</tbody>
</table>

The Herfindahl indices (Table 3), with respect to gross premiums, show that general and life insurance market structures are oligopolistic in nature and dominated by the few firms, equivalent to about four and three firms of equal size, respectively.

Table 3: Reciprocal of the Herfindahl Index

<table>
<thead>
<tr>
<th>Year</th>
<th>General insurance</th>
<th>Life insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>2.9</td>
<td>1.8</td>
</tr>
<tr>
<td>2003</td>
<td>4.0</td>
<td>3.0</td>
</tr>
<tr>
<td>2005</td>
<td>4.2</td>
<td>3.1</td>
</tr>
</tbody>
</table>

The most important determinant of the competitive level has been the government-imposed constraints, including high entry barriers and business restrictions. Foreign-invested insurance firms have been limited to provide insurance services to enterprises with foreign-invested capital and foreigners working in Vietnam, and have not been allowed to engage in statutory insurance business. The existing institutional arrangements have inhibited efficient competition and generated adverse effects for the industry’s efficiency.

During the past two years, much progress has been made in improving competitive conditions. Firms have started to take active measures to enhance their competitive performance in the market, including introducing new products, diversifying their investments, risk-management, and providing risk control education and training for staff. All those changes indicate that firms are better situated to improve efficiency. Vietnam’s WTO commitments relating to the insurance industry focus on two points: setting prudential regulation for issuing licenses, and lifting the geographic and business scope limitations. These commitments will stimulate foreign entry and improve the competitive conditions of the insurance industry. The removal of various restrictions could provide a leveller playing field for different firms so that they could compete with each other through efficiency and innovation. The transformation of state-owned firms into joint-stock firms could help firms enjoy greater autonomy in their management and as such their efficiency could increase. In addition, listing firms on the stock exchange market could give them operational independence.
Competition in Vietnam’s insurance industry is more than rivalry among firms. Whether competition can contribute to firms’ efficiency performance depends significantly on legal institutions that govern competitive behaviour. Improving competitive conditions requires fundamental institutional changes. However, this process should be approached cautiously. A sound legal, regulatory, and supervisory framework should be established together with this reform process. Such a legal framework will not only help reduce the insurance industry’s fragility, but will also contribute positively to efficiency by reducing the transaction costs involved in the insurance industry. In an environment of increased structural deregulation, insurers require more refined management in order to improve their performance. This would help them to catch up with the efficient frontier. Upgrading and expanding the distribution channels with gradual utilisation of information technology may be one option. The use of information technology and other innovative processes and organisational techniques that raise organisational efficiency must be encouraged. The efficiency of both non-life and life insurers is affected by the firm size. This implies that there may be efficiency gains from insurers using growth strategies, by increasing the scope of business through internal expansion. This can be done by listing joint-stock insurers in the security market.

The adjustment should be supported by the improvement of insurance prudential supervision. Following the deregulation, a supervisory system of the Vietnamese insurance industry is needed to re-examine and adjust so as to be appropriate for a more competitive financial environment. Increasing transparency policies, such as shifting some responsibilities for supervision onto insurers, and implementing financial self-monitoring regulations by the insurance industry, should help to reduce the risk of insolvent which, in turn, assists insurers’ effective management.

The Vietnamese insurance industry is becoming more competitive; insurers are desperate for effective investment in order to support their development. The change in the economic and financial environment would also bring more pressures on insurers’ operation. In this context, one possible policy suggestion is that business insurance restrictions should be relaxed to allow insurers more freedom in the choice of doing their businesses. Relaxing restrictions on insurance operations such as business scopes, demographic locations and entry would contribute to the business expansion of insurers and the development of the insurance market, thereby improving their efficiency and productivity growth.

Figure 1: Growth in Insurance Penetration (1994-2004). Insurance Penetration = Gross Premium/GDP

Electrifying Integration

Liz Hooper and Andrei Medvedev

Energy is high on political and, arguably, public agenda at national and international levels, and debate reflects the concerns about the sustainability of economic development, competitiveness and security of supply that motivate national and regional energy policies. Economic theory shows that competitive markets deliver timely and efficient investments which support these objectives by ensuring allocative efficiency. Thus reform of the energy sector through the introduction of competitive markets in generation and supply is central to an effective energy policy.

During the last decade South East Europe (SEE) witnessed several conflicts and the collapse of the socialist system, but finally, after years of turbulence, it appears that sustained economic growth is within the grasp of the SEE nations and states. But experience in other transition and developing economies suggests that achieving this goal is contingent on reform of the energy sector. In late 2005 the countries of SEE and the European Commission (EC) signed the legally binding treaty establishing the Energy Community, which entered into force on 1 July 2006. The Treaty reflects the close alignment of the objectives of the EC and the nations of SEE in terms of deeper integration within and between regional markets. The signatories to the Treaty, which are the subject of our study, all are either members of the EU or have a common ambition of membership. In line with the EU energy policy, and their commitments under the Treaty, the Parties resolved to establish an integrated competitive market for electricity and gas based on the development of stable regulatory and market framework and a ‘single regulatory space for trade in electricity and gas that is necessary to match the geographic extent of the concerned product markets’.

Under the research theme Regime Dynamics, CCP’s Project 5 is concerned with sequencing competition and regulatory policy reform in the electricity markets of SEE. We are conducting an analysis of electricity generation in SEE in which we first outline the essential characteristics of this link in the supply chain, and go on to consider some of the key challenges and implications of the formation of a regional market for energy in SEE.

The electricity systems in the region exhibit a mixture of mature (though in places degraded) networks, a large proportion of low-income consumers, and poor social safety nets. Generation in the region is currently dominated by fossil fuels; while there is little natural gas, there are substantial deposits of lignite and coal. In terms of renewables and low-carbon technologies, several systems are hydro-based and there is some nuclear capacity, though the potential for significant wind generation is low. In the absence of very significant investment in electricity generation and transmission capacity, the security of the entire electricity system will be compromised. This would pose a serious threat to the economic recovery that continues to support the peace and stability that has
implies a potential saving of around €34bn and €37bn, which implies a potential saving of around €3.5bn.

An efficient regional energy market allows to better meet peak demand in individual countries, makes the supply of electricity more stable and reliable across the region, encourages private investment in the sector, and matches the growing demand for electricity in the long-run. Furthermore, it allows nations with small systems to benefit from the economies of scale that characterise the industry and that would not otherwise be feasible. However, each type of fuel bears various risks for customers, energy companies and countries. Dependency on such types of fuel as hydro and thermal electricity could expose countries to physical supply shortages in a case of unfavourable natural or market conditions. Private investors prefer transparency and predictability in regulatory and environmental policies when developing capital intensive nuclear and thermal generation facilities rather than risking additional costs of complying with newly introduced stricter environmental laws. On the demand side, it is common to hear final consumers voicing concerns about price risk that they would bear after the liberalisation of the electricity market. This fact could lead to an additional political pressure on politicians and regulators that could result in a halt or even reverse of reforms in the sector.

We are currently conducting preliminary analysis of electricity generation in SEE as part of a book on the topic to be published later in 2007. This will identify the key challenges that face the Energy Community of South East Europe and, by implication, for the Energy policy of the wider EU. We will present our chapter at a project workshop in Romania in July 2007.

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To determine whether marketing activities are an issue within individual cases, the incidence and context of the word ‘marketing’ and key marketing terminology, was recorded for all selected 161 studies. From this assessment, 57% of the cases report ‘marketing’ or key marketing terminology as a factor within the case, and 13%
emphasise ‘marketing’ as a central cause of the competition complaint. The distribution of competition cases which are, and are not, linked with marketing is displayed over time in Figure 1.

Based on our assessment a number of findings are reported. First, the financial scale (in real terms) of markets investigated by the different Competition Commissions has increased over time, while the number of firms involved in each case has declined. Second, both the number of cases examined and the proportion of adverse judgements where behavioural and/or structural remedies are imposed have risen consistently over time. Third, the competition cases linked with marketing contain a wider range of anticompetitive activities relative to the cases where marketing is not identified. Fourth, the marketing cases occur in larger markets and involve more companies. This is indicative of competition cases associated with marketing being relatively large and complex.

Following this assessment of the frequency of cases which have included marketing decisions, the forms of anticompetitive practices and marketing behaviour are assessed. This was undertaken through reading each of the 161 cases and classifying the anticompetitive practices and marketing behaviours.

From this review a wide range of features are identified and presented in Figure 2. What is clearly identified from this assessment is the prominence of marketing within certain forms of anticompetitive behaviour. For example, as pricing is a central function of the marketing department it is unsurprising that excessive pricing has frequently been linked to marketing decisions. However, the most significant source of marketing-related cases is the presence of vertical restraints. Here we undertake a brief discussion of how marketing decisions are associated with these two forms of anticompetitive behaviour to illustrate some of the numerous links between marketing behaviours and competition law violations.

**Figure 1: The Frequency of Competition Cases Including Marketing Concerns**

Excessive pricing concerns arise especially when undertaken by a dominant firm, and are more broadly considered symptomatic of anticompetitive markets. Excessive prices are identified when prices are higher than might be expected in a competitive market. As pricing is a principal marketing function, it is not perhaps surprising that 67% of all excessive pricing cases (46 cases) implicate marketing in this form of anticompetitive behaviour. In most cases the incidence of excessive prices is associated with either brand building, considered next, or the ‘appropriate’ role and degree of marketing spending.

Branding decisions can raise anticompetitive concerns when a dominant firm does not compete on price, and customer offerings are differentiated. By building and using brands, dominant firms can alter the form of competition. For example, in the investigation of the UK breakfast cereals market (1973) “…advertising and promotion have helped to create and tend to maintain the kind of market in which it is possible for manufacturers to have substantial freedom to determine their prices as they wish” (Breakfast Cereals 1973, para. 88). The main competitive concerns occur when low levels of customer price sensitivity exist and customers rely on brands to inform their choices. This may result in a relatively restricted market, such as that observed in the Tampons (1980) case. In this case the competition authority argued, “The main difficulties seemed to us to lie on the marketing side and to arise from the unusual degree of brand loyalty and from the limited nature of the market” (para. 2.21). In this regard, there is a schism between the marketing perspective that effective branding recognises that some brands will attract premium prices, and the commission view that branding is used to provide firms with more defensible products that potentially damage competition.

**Figure 2: The Frequency of Anticompetitive Behaviours and Marketing Practice**

Vertical restraints include the set of business-to-business and business-to-customer relationships which impose certain restrictions on the sale and supply of goods and services. If these restrictions are used by a dominant firm to limit present or future competition, an anticompetitive action is identified. The association between vertical restraints and marketing rests on the need to build relationships with suppliers and customers, a strategy widely recommended throughout the contemporary marketing literature. Indeed, relationships with suppliers have been mooted by a number of marketing scholars as an effective method of reducing the impact of competition on an industry. We found that 61% of cases involving vertical restraints (65 cases) implicate marketing in this form of anticompetitive behaviour.

A particularly persistent form of vertical restraint is the exclusive supply of goods and services by a dominant firm. These exclusive agreements arise for a variety of reasons including the payment of discounts, other financial or material special terms, and, in some instances, through ‘market indoctrination’. This form of vertical restraint agreement has been reported repeatedly in a number of industries over the sample period (e.g. Petrol 1965, 1979; Electric Lamps 1952, 1968; Ice Cream 1979, 2000) and is demonstrably linked to marketing practices. For example, in the distribution of Carbonated Drinks (1991), the main suppliers to this market required the exclusive distribution of their products for the receipt of special terms from distributors – a practice viewed as limiting choice and
leading to higher prices. A second form of vertical restraint linked with marketing occurred in the exclusive purchase of goods and services from supplier firms. In the supply of Car Parts (1982), manufacturers’ insisted “on the use of their brand names” (para. 4.50) on components, rather than the brand of specialist component manufacturers. This practice was employed with “the purpose of branding car parts...to ensure exclusivity” (para. 4.48), a mechanism viewed by specialist component manufacturers to protect them from competition. Similar forms of exclusive supply have been observed in other cases. For example a dominant retailer may make financial demands for the promotion of the supplier’s products (Supermarkets 2000) or where exclusivity is enforced through demands for products supplied to very particular specifications (Domestic Gas Appliances 1980).

To conclude, the continued assessment of competition decisions, analysis of how these decisions are made and the wider implications of such judgements, are required to both develop greater awareness of competition law and to reduce future abuses. This study provides the first step in exploring these anticompetitive concerns for different functional areas of the firm. It is reported that the functional area of marketing has had an important role in the development and exercise of many anticompetitive actions. Equally, greater engagement and discussion of competition policy with the marketing discipline may also be an important way forward in addressing anticompetitive behaviours and improving the competitiveness of markets.

**The Paradox of the Exclusion of Exploitative Abuse**

*Bruce Lyons*

European Commissioner Neelie Kroes kicked off the current major review of Article 82 by saying: ‘it is sound for our enforcement policy to give priority to so-called exclusionary abuses, since exclusion is often at the basis of later exploitation of customers’. This is a common position to hear in policy circles, but it is inherently paradoxical. If exclusionary abuses are bad because they ultimately exploit consumers, why should the policy emphasis not be on directly exploitative abuses? The answer has direct relevance for the current Article 82 review: should exploitative abuses be integrated alongside exclusion in the emerging guidelines?

This may seem like an esoteric debate to some readers, but it translates into fundamental guidance for business, as well as competition practitioners, as to what is and is not lawful behaviour for businesses that dominate their markets. I begin by clarifying what is at issue. There are two ways in which a dominant firm might abuse its market position. First, it might directly harm its customers; for example, by raising prices or limiting its effort to lower costs or develop new products. This is known as an exploitative abuse. Second, it might adopt strategies that exclude rivals from making an effective challenge to its dominant position; for example, by predatory pricing, product bundling, exclusive contracts or refusal to supply. Collectively, these are known as exclusionary abuse.

The formal EC law covers both types of abuse, and provides little guidance on whether exploitation or exclusion should be the greater concern. The case law, however, has greatly emphasised exclusionary effects, with exploitative effects appearing to be little more than a sideshow. It is in this context that DG Comp’s opening, and so far only, major public contribution to the review of Article 82 has been the much discussed staff paper on exclusionary abuses. There has been no public commitment as to the next stage of review, but it is likely that the working paper will be developed into a set of guidelines.

**“The case law has greatly emphasised exclusionary effects, with exploitative effects little more than a sideshow”**

Exploitation of consumers is the textbook abuse by a monopolist or dominant firm. Because consumers cannot easily switch to an alternative source of supply, the dominant firm can raise price to enhance profits. Consumers lose out by having to pay more and buy less, and there is a consequent distortion in the allocation of resources. All economics students learn this in their first year of study, and it is a major justification for competition policy. Exploitation is the most direct form of abuse.

However, most competition economists (and probably also most competition lawyers) have a profound distaste for the direct control of exploitative abuses. It conjures images of detailed regulation, and most would argue that it should be reserved for cases of genuine natural monopoly (e.g. privatised utilities which cannot be structured competitively due to network economies). The latter require specific, well informed regulators, and these cannot be put in place for all corners of the economy in which a firm may be dominant. Far better, the argument goes, to concentrate on maximising the chances for the competitive process to throw up a new competitor; hence, the focus on exclusionary abuses.

**“It is widely agreed we should prohibit only those exclusionary practices which can be expected to result in an exploitative abuse...”**

Before assessing whether this should be the end of the story, we take a step back to recall the DG Comp review of exclusionary abuses. The main thrust has been that the key test should be ultimate consumer effects, and not protecting rivals per se. This was anticipated by Ms Kroes in her Fordham speech: ‘First, it is competition, and not protecting rivals – as long as it ultimately benefits consumers.’ Many of the details of the subsequent working paper have been criticised, particularly for not achieving this aim, but this main thrust on consumer effects has received almost universal acclaim. It is certainly a view shared by most competition economists.

So, we have a strong consensus that exclusionary abuse is where a dominant firm hurts rivals and thereby indirectly harms their customers. Importantly, while hurting one or more rivals is necessary for an exploitative abuse, it is not sufficient – to be an abuse, exclusion also requires an expectation of eventual consumer harm (i.e. exploitation). This results in our paradox: it is good to prohibit only those exclusionary practices which can be expected to result
(indirectly) in an exploitative abuse but at the same time it is bad to prohibit directly exploitative practices!

"...but paradoxically it is also believed to be bad to prohibit directly exploitative practices!"

The remainder of this short paper considers four arguments that soften the edge of this apparent paradox. In comparison with exclusionary effects, exploitative effects tend to be:

1. Naturally shorter lived and more dangerous to remedy (Type 1 error)
The fundamental process of competition is that smaller firms expand and new firms are attracted by profitable opportunities. As these minnows grow, a slack incumbent will see its dominant position erode unless it responds positively with a better product offering (including price, quality and variety). In a well functioning market, exploitive dominance is naturally self-limiting. In contrast, there are ever-present dangers of regulators getting it wrong due to asymmetric information and distorted incentives.

By comparison, the remedies for exclusionary abuse tend to be less dangerous to the competitive process. For example, a dominant firm may be required to provide access agreements or not to sign exclusive contracts. Although these remedies might undermine investment incentives if they are wrongly imposed, at least they do not undercut the profitability of entry.

2. Mainly possible due to strategic entry barriers
It is possible to distinguish two generic types of entry barrier: structural and strategic. A structural barrier is created by natural supply and demand conditions in the market; for example, where the technology dictates large economies of scale. A strategic barrier is created by a dominant firm, which deviates from short-term profit maximising behaviour in order to exclude an existing or potential rival; for example, signing exclusionary contracts that do not significantly improve investment incentives. If all barriers to entry were strategic and readily prohibited by a focus on exclusionary effects, then exploitive behaviour could not last long. Of course, the existence of structural barriers in some markets means that exploitation may persist.

3. Harder to prove to the standard required by the Court
It is notoriously difficult to prove that prices are excessive, let alone that a dominant firm is falling short in terms of quality, variety or innovation. There is an almost complete lack of easily observable benchmarks for most dimensions of competition, though there may be some loose comparisons to be made with related products, internationally or over time. For price, at least cost or margin benchmarks can be collected, but there is always a problem in deciding what is a reasonable price in relation to costs. The problems are even greater when there are shared overheads, or when there are short term movements in cost or demand conditions. In the face of such problems, it is often argued that price negotiations should be a matter of freedom of contract between buyer and seller. In contrast, it may be easier to prove that rivals or potential rivals are being harmed by some exclusionary practice and to identify the expected direction of effect on customers (and so eventually on consumers). A similar argument can be used in relation to merger appraisal, where the direction of effect is also what is primarily at stake. Furthermore, in seeking evidence for exclusionary effects, DG Comp can rely on the very active help of injured third parties who will normally have much more at stake than individuals from a more dispersed customer base at the wrong end of a directly exploitative abuse.

4. Politically more difficult to deal with
Two examples illustrate this general point. First, US practice has evolved very much in terms of exclusionary effects, which may also reflect section 2 of the Sherman Act which prohibits monopolisation. It might be argued that, with the emergence of global corporations, it would be good to harmonise what competition agencies do. Apart from political benefits of avoiding trans-Atlantic disputes, harmonisation also provides a clearer signal to firms and so may encourage compliance. Second, competition agencies have an important advocacy role: competition is good for both consumers and firms. If they get this message across, they gain valuable allies, creating status and enhancing funding. Firms find it difficult to understand why they should not maximise profits, and exploitative abuses by one firm are an opportunity for others. Thus, while the business sector gains broadly by ‘exploitation’, rival firms are hurt by exclusionary abuses and so support their prohibition.

Conclusion
Overall, these arguments support the view that there is justification for a continuing focus on exclusionary abuses. However, it would be unwise to dismiss the core paradox I have identified. It is important to keep alive the principle of exploitative abuses because:

- Some such abuses can be remedied without reinforcing dominance
- Some barriers are structural
- Some exploitative abuses can be proved
- Political side-effects should not be an agency’s prime concern

Having established this important niche role, it is then entirely appropriate for exploitative abuses to be included in any Article 82 guidelines. Nevertheless, it must be conceded that the prohibition of exploitative abuses should be undertaken only with great caution. Ms Kroes is broadly right that the implementation of Article 82 to prioritise abuses that affect the fundamental process of competition.

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1 This article is based on a speech I gave to the ECN Chief Economists in Stockholm (September 2006). While the views expressed are my own, they were greatly developed by a CCP brainstorming session prior to the ECN conference.
3 Article 82 of the EC Treaty prohibits the abuse of a dominant position, and highlights: ‘unfair’ pricing or trading conditions; ‘limiting’ production or technical development; applying dissimilar conditions to equivalent transactions; and ‘supplementary obligations’ in contracts.
4 See e.g. Whish ‘Competition Law’ (2004) ch.5.
5 See also the discussion of appropriate economic principles by the EAGCP published on the DG Comp website.
6 For example, see the EAGCP report, op. cit. This is not to deny disagreements over consumer versus total welfare as the appropriate standard.