Competition Policy Assessed – US to EU via UK

Director's Letter

Catherine Waddams

The papers in this newsletter illustrate very well the range of CCP's academic programme of work on current Competition Policy areas, covering legal and economic perspectives, using theoretical and empirical methodology, and addressing mergers, regulations and general antitrust policy, in the EC, the UK and the US. Firat Cengiz, fresh from her research in Washington, discusses the changes proposed by the US Antitrust Modernization Commission, while Kathryn Wright considers the award of compensation against the EC in a merger case where they lost an appeal against their adverse finding. More encouragingly for the EC, Luke Garrod presents a model which supports their recently introduced regulations requiring airlines to nominate prices inclusive of taxes, fees and charges, supporting his argument that the 'free things in life are not always the best'. John Ashton and Khac Pham report CCP research which establishes that efficiency effects of mergers have not been consistently shared with consumers in the UK banking sector, indicating that competition authorities are right to be sceptical of claims that mergers should be allowed because of such potential efficiency gains alone. We welcome comments on this and other aspects of our work.

During the last six months we have held three academic events. The annual summer conference, 'Comparative Perspectives on Multi-Jurisdictional Antitrust Enforcement', attracted excellent speakers and lively debate, and the PhD workshop which was held in association with it brought nine PhD students from outside UEA to join the 14 doctoral students in CCP for a week of papers, discussion and contact building. See the boxes on page 4 for details of next year's summer conference on the interaction between regulation and competition policy; and for those of a joint conference on behavioural economics being held with the School of Economics at UEA. At the beginning of July the CCP group working on reform of the electricity sector in South East Europe joined fellow authors on the project for an intensive two-day conference in Sinaia, Romania, which generated very frank and informed discussion on the challenging academic, political and pragmatic issues concerned, as well as an excellent atmosphere for both work and relaxation. Other invited guests included Violeta Kogalniceanu from the Energy Community Secretariat who encouraged us in our project and updated us on the European Commission's policy and implementation of the regional energy market in South East Europe. The collected papers from this stage of the project will be published in a special edition of Utilities Policy next year.

We also participated in the initial meeting of a Network of European Institutes for Competition Law and Economics, initiated jointly by CCP and the Tilburg Law and Economics Center. Members of the network are committed to exchanging ideas and offering opportunities for researchers, especially at junior level, to spend time in other research institutes with similar multidisciplinary approaches. A workshop is planned in December in Bonn, and CCP will be organising a PhD workshop for Centre members in late Spring 2008.

As CCP enters its fourth year, staffing changes continue. Hayley Morris, who has been Centre Manager for two years, left in August, and has been replaced by Stuart White. Khac Pham, who completed his PhD on reform of the insurance industry in Vietnam last year, and has been working as a research associate in the Centre since then, returned home to Vietnam in August to work in the private sector. Laurence

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Mathieu, who has been on maternity leave since last year, returned to CCP as a part-time research associate for a few weeks in the Autumn before resigning to spend time with her growing family. And Lindsay Stirton, Lecturer in Law, departed in October for a lectureship at Manchester University. We thank all concerned for their contributions to the Centre, and wish them well in their new ventures. Several members of CCP have recently increased their role in the Centre. Greg Shaffer, Professor of Economics and Management and of Marketing at the Simon School of Business, University of Rochester, USA, an associate member who made his second visit of several weeks this summer, has been appointed to a part-time Chair in the School of Economics; Hussein Kassim, the Centre's Political Science mentor, has been appointed to a Chair in the School of Political, Social and International Studies at UEA. Two CCP law students, Pinar Akman and Andreas Stephan, who are nearing the end of their PhDs, have been appointed to lectureships in Norwich Law School. Zhijun Chen, an economist, and Liza Løvdahl-Gormsen, a lawyer, have joined Andrei Medvedev as new Post Docs. Judith Mehta joined the Centre as a part-time Research Co-ordinator in October as did Hieu Tran, full-time temporary Research Associate. Within UEA, Professor Graham Loomes from the school of Economics has become a member of the Centre. We extend a very warm welcome to all these new members, and to old friends in new roles, and look forward very much to working together in the coming months and years.

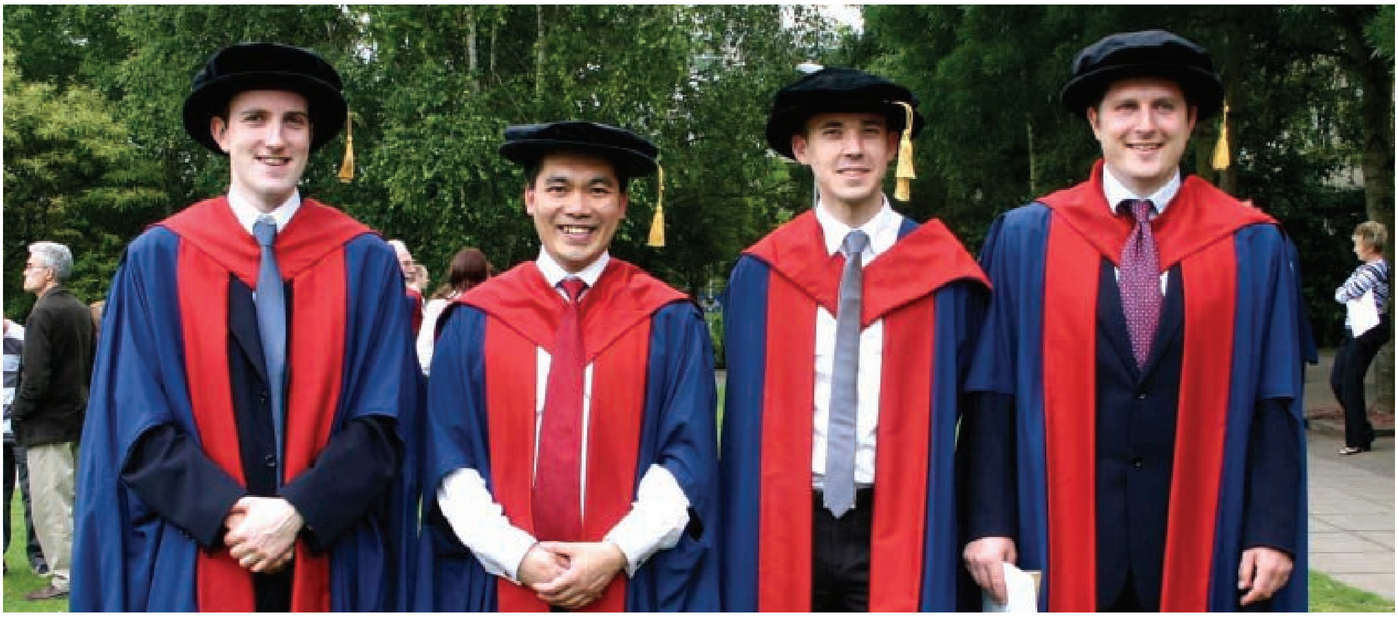
One mark of the Centre's progress is the success of several PhD students who graduated this summer - Andy Bugg, Nicola Mazzarotto, Chris Pike and Chris Wilson graduated in Economics, and Khac Pham in Business. With the exception of Nicola, all were present at the graduation ceremony, where we managed to capture the moment in the photograph below.

Indeed, the Centre for Competition Policy recently received recognition from the Economic and Social Research Council as a "+3" training outlet for doctoral students. We are delighted to have received this acknowledgement of the quality of the research training offered by the Centre, where we see training the next generation of competition and regulation policy analysts as central to our role.

As well as our regular programme we are undertaking research projects for the Office of Fair Trading on Activating Consumers and on the effects of abolishing the Net Book Agreement, and for the department of Business, Enterprise and Regulatory Reform on Consumer Empowerment. We are looking forward to discussions with several visitors before Christmas - Paola Valbonesi in October, Stephen Wilks and Frode Steen in November and Kai-Uwe Kuhn in December.

Finally, we want to thank those who responded to the communications survey contained in our last newsletter. The responses we received have enabled us to plan improvements in our communication of the Centre's output to our contacts – in particular, the e-bulletin. We discovered that the distribution base for this monthly email is much larger than our database shows, due to recipients forwarding it to their colleagues, and that an encouraging proportion of our contacts find the research featured in e-bulletins relevant and useful to informing their own work. The survey responses also showed that while the majority of respondents are happy with the newsletter, there are areas that could be improved, such as content: for the next issue we will be considering the inclusion of summaries of the research projects that are ongoing within the Centre.

l-r: Chris Wilson, Khac Pham, Chris Pike, Andy Bugg



News from the US: Report of the Antitrust Modernization Commission

Firat Cengiz*

Periodical revisions of the federal antitrust policy through the so-called "blue ribbon" commissions are not unusual in the US.[1] The latest example of those commissions, the Antitrust Modernization Commission (AMC), came into existence in 2002 as a result of the efforts of Congressman F. James Sensenbrenner, a Republican from Wisconsin and the Chairman of the House Judiciary Committee. The Act establishing the AMC devoted significant effort to create a commission with bipartisan nature in terms of its composition[2] and granted the AMC a general authority to study and revise the federal antitrust policy rather than raising specific issues.[3]

The AMC enjoyed full discretion in terms of defining its own agenda. Immediately after the AMC's inception, the Commissioners decided to pursue a comprehensive agenda which addressed substantive, procedural and enforcement aspects of the policy.[4] In general however, the AMC's agenda focused on the challenges facing any jurisdiction which aims to sustain effective antitrust enforcement under the forces of globalisation, deregulation and rapid technological expansion.

Hearings before the AMC and the debates within the antitrust community regarding the issues raised by the AMC were vigorous, exciting and fruitful. After five years of continuous work, the AMC finally published its widely expected report in April 2007. In general, the Report concluded that the federal antitrust policy as it stands today is built on sound economic and legal principles and consequently it did not propose any dramatic legislative amendment, with the exceptions of indirect purchaser actions for treble damages and the Robinson-Patman Act regulating price discriminations. The Report commented that the federal antitrust policy has already been "modernised" by the judiciary since the adoption of the Sherman Act in 1890 thanks to the general and open-ended nature of the federal antitrust statutes, and even if there is room for improvement today on specific issues, judicial improvisation should continue to be the main mechanism of modernisation.[5]

In terms of merger enforcement, the AMC suggested that the federal authorities and courts give more credit for certain fixed-cost efficiencies, such as research and development expenses in dynamic, innovation-driven industries.[6] Furthermore, it also contended that the Federal Trade Commission and the Department of Justice (DOJ) should conduct empirical studies regarding the relationship between concentration, other market characteristics and market performance, and the real-world implications of past mergers.[7]

In terms of monopolisation, the AMC commented that in general the federal policy appears satisfactory. However, it also gave a warning to the courts on two grounds. Its final report claimed that it is not altogether clear to what extent bundled discounts or rebates and refusals to deal with the rivals in the same market violate Sherman Act § 2, and called on the courts to adopt consistent standards on these issues immediately.[8]

Recommendations of the AMC regarding the relationship between intellectual property rights and antitrust policy constituted one of the most anticipated parts of the Report. Nevertheless, the AMC did not come to any strong conclusions in this regard and confined itself to referring to the former reports of the Federal Trade Commission[9] and the National Academy of Sciences,[10] to which it called the Congress to give serious consideration.[11]

In terms of international antitrust enforcement, the Report proposed that the federal authorities should seek international convergence on sound procedural and substantive standards,[12] and based on the 2003 PricewaterhouseCoopers Survey which estimated the cost of an average merger at around $3.8 million in the presence of 70 jurisdictions with a compulsory merger review process,[13] it recommended that the authorities study and report to the Congress the possibility of a centralised global merger filing system.[14]

In terms of private actions for damages, the AMC came to the conclusion that the federal policy functions effectively overall. However, it contended that in some instances the principles of joint and several liability of the defendants, together with the lack of a principle of contribution, pressurise the defendants to enter into settlements with the plaintiffs and cause over-deterrence. Therefore, the Report suggested that the Congress enact a statute that would permit non-settling defendants to obtain reduction of the plaintiffs' claims by the amount of the settlement(s) or the allocated share(s) of liability of the settling defendant(s) – whichever is greater – and allow claims for contribution among the non-settling defendants.[15] Most surprisingly, the AMC did not propose any legislative amendment to repeal the enforcement authority of the State Attorneys General.[16] After the *Microsoft* litigation, where the Attorneys of ten States and the District of Columbia sought stricter remedies despite the DOJ's decision to settle the case, criticism regarding the enforcement efforts of the State Attorneys had reached a climax[17] and the former memoranda of the AMC signalled that the final Report might propose a significant restriction of the State AGs' enforcement authority.[18] Nevertheless, the Report confined itself to recommending better mechanisms of cooperation and coordination between the federal and state authorities and left it to the discretion of the authorities to take positive action for improvement.[19]

The Report proposed significant amendments only on two accounts. First, the Report called for the formal abolition of the Robinson-Patman Act, a statute long *de facto* dead, on the grounds that the Act protects competitors and harms consumer welfare by prohibiting and discouraging price discrimination that lowers prices for consumers.[20] Second, the Report recommended that the Congress repeal the *Illinois Brick*[21] doctrine which denies standing to the indirect purchasers in claims of treble damages, and the *Hanover Shoe*[22] doctrine which prevents the defensive use of pass-on arguments in actions for treble damages. The report concluded that these doctrines raise serious fairness issues as they result in denial of damages to end consumers who shoulder the welfare impacts of antitrust violations.[23] As 36 States and the District of Columbia recognise the right of the indirect purchasers to obtain treble damages in their state antitrust laws, at present indirect and direct purchasers seek relief against the same violations through independent actions before the state and federal courts at the expense of wasting public resources and causing inconsistent judgments and duplicative recoveries. Therefore the AMC recommended that the Congress recognise the right of the indirect purchasers to obtain treble damages and adopt procedural mechanisms whereby state and federal indirect and direct purchaser actions can be transferred to the same federal court to be litigated through a single and universal action.[24]

All issues raised and addressed by the AMC Report appear potentially interesting and beneficial for the comparative analysis of the EC-US antitrust policies and for transatlantic policy learning. The issue of indirect purchasers distinguishes itself amongst the others, however, since the European Commission's widely debated Green Paper on private actions specifically raises the questions whether the indirect purchasers should have standing in actions for damages and whether the pass-on defence should be recognised in Europe.[25] Therefore, it will be interesting for the European antitrust community to observe the reactions of American antitrust scholars, and ultimately the Congress, to the recommendations of the AMC.

* The author is grateful to the ESRC for the financing of her research visit to the Georgetown University Law Center.

1 See Albert A. Foer, "Putting the Antitrust Modernisation Commission into Perspective", (2003) 51 Buffalo Law Review 1029.

2 Antitrust Modernization Commission Act of 2002, 116 STAT. 1856, SEC. 11054.

3 *Ibid.*, SEC. 11053.

4 See the list of the study groups formed by the Antitrust Modernization Commission at http://www.amc.gov/pdf/meetings/list_of_study_groups_rev.pdf

5 Antitrust Modernization Commission, Report and Recommendations, April 2007 (hereafter "the Report"), available at http://www.amc.gov/report_recommendation/amc_final_report.pdf, p.z, 90.

6 *Ibid.*, p.56.

7 *Ibid.*, p.61.

8 *Ibid.* at 83.

9 Federal Trade Commission, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy* (2003).

10 National Research Council of the National Academies of Sciences, Committee on Intellectual Property Rights in the Knowledgebased Economy, *A Patent System for the 21st Century* (2004).

11 The Report, *supra* n 5, p.119.

12 *Ibid.*, p.214.

13 PricewaterhouseCoopers, *A Tax on Mergers? Surveying the Time and Costs to Business of Multi-jurisdictional Merger Reviews* (2003), p.42.

14 The Report, supra n 5, p.214.

15 *Ibid.*, p.244.

16 State Attorneys General are the chief legal officers of the States who enforce the antitrust statutes through actions for damages and injunctions they bring before the courts on behalf of the citizens and the State in their *parens patriae* capacity.

17 See e.g. Richard Posner, "Antitrust in the New Economy" (2001) 68 Antitrust Law Journal 925.

18 US Antitrust Modernization Commission, Enforcement Institutions-States Discussion Memorandum, 19 May 2006, available at http://www.amc.gov/pdf/meetings/EnfInst_State_DiscMemo_pub.pdf

19 The Report, *supra* n 5, at 187.

20 Ibid., at 312.

21 *Illinois Brick Company et al. v. State of Illinois*, 431 U.S. 720 (1977).

22 *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968).

23 The Report, *supra* n 5, at 267.

24 *Ibid.*

25 European Commission, Green Paper on Damages Actions for Breach of EC Antitrust Rules, Brussels, 19.12.2005 COM(2005) 672 final, available at http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0672en01.pdf

Judicial Scrutiny of Merger Decisions, Damages and the *Schneider* Electric Case

Kathryn Wright

The European Court of First Instance (CFI) recently awarded compensation for the first time in a merger case, in *Schneider*.[1] Although the damages were granted as a result of procedural shortcomings, the case once again highlights the question of the appropriate 'margin of discretion' for the European Commission where it makes economic assessments, and the role of the courts in supervising the decisions of administrative bodies. The case reverberates from the trio of adverse merger rulings against the European Commission in 2002 – Airtours, Schneider and Tetra Laval,[2] and MyTravel's compensation claim relating to the blocked Airtours merger is still pending.

The right to compensation emanates from Article 288 of the EC Treaty, which provides that in the case of non-contractual liability, the Community shall make good any damage caused by its institutions. Article 235EC grants Community courts jurisdiction to award compensation where the Commission is found liable for that damage.

As the CFI indicated in *Schneider*, for the Community to incur non-contractual liability there must have been unlawful conduct on the part of the Commission, that is, "a grave and manifest disregard of the limits of their powers of assessment". The three conditions for awarding compensation based on non-contractual liability are a sufficiently serious breach of a rule of law intended to confer rights on individuals; actual harm to the claimant; and a causal link between the breach and the harm.

Schneider Electric

The original merger control proceedings in 2002

In October 2001 the Commission declared the acquisition of Legrand by Schneider, two large French industrial groups in the electrical equipment sector, to be incompatible with the common market as it would impede significantly effective competition in the French sectoral markets. As the acquisition had already gone ahead, the Commission also adopted a decision in January 2002 ordering Schneider to divest itself of Legrand.

Schneider applied to the Court of First Instance for annulment of both Commission decisions. In the meantime, anticipating that its application may be dismissed, it prepared to divest Legrand by concluding a contract in July 2002 with the Wendel/KKR consortium, which had to be executed by 10 December 2002.

On 22 October 2002, the CFI annulled the Commission's prohibition decision (and with it the divestiture order), ruling that the Commission had infringed Schneider's rights of defence: it had raised for the first time in its final prohibition decision an objection to the merger relating to the reciprocal 'buttressing' of Schneider and Legrand's respective leading positions in the French markets.

The resumed merger control investigation

After the CFI annulled its decision blocking the merger, the case reverted to the Commission for reinvestigation. Faced with continuing doubts that its proposals would bring the merger into line with the common market, Schneider abandoned the transaction and executed the contract of divestiture with Wendel/KKR on 10 December 2002. The Commission therefore closed its file three days later. Schneider then brought an action for damages for the loss it had allegedly suffered as a result of the Commission's wrongful prohibition decision.

The CFI's judgment in July 2007

The Court said that the denial of Schneider's right to be heard on the buttressing arguments meant that it was unaware that there was no prospect of the merger being declared compatible with the common market unless it submitted corrective measures which would remedy those concerns.

The most significant point is that the damages arose from the denial of Schneider's right to be heard rather than an error of assessment in the Commission's reasoning. The CFI summed up the balancing act between allowing the Commission discretion, and protecting the firms it polices:

> *"The purpose of defining a threshold at which the Community may incur non-contractual liability is to protect the latitude and discretion which, in the public interest, the community competition regulator must enjoy, both in its policy decisions and in its appraisal and application of relevant provisions of Community law, while ensuring that the costs of the consequences of flagrant and inexcusable failings does not fall on third parties."*[3]

The Court held that Schneider should be compensated for two categories of losses: (1) costs incurred by Schneider in the Commission's renewed merger investigation procedure after the Court's annulments in 2002, and (2) the reduction in the divestiture price conceded to Wendel/KRR to postpone the transaction. Only two thirds of the divestiture loss is to be compensated as Schneider contributed to its own loss by assuming that the merger would subsequently be declared incompatible.

The Commission's appeal to the ECJ

Perhaps alarmed by the prospect of opening the floodgates to a deluge of other damages claims, the Commission has lodged an appeal with the European Court of Justice. It disputes the finding that the infringement of Schneider's procedural rights during the original 2001 investigation was a "sufficiently serious breach" to warrant a claim for non-contractual liability. It also bases its appeal on the lack of causal link between the Commission's alleged breach of Schneider's procedural rights and the second head of damages, that is Schneider's sale at a loss of Legrand to Wendel KKR. The Commission contends that Schneider itself brought about its loss by selling the company, pre-empting the outcome of the Commission's reinvestigation. The Commission had suspended its divestiture decision following the CFI's October 2002 ruling, extending the deadline to February 2003, so Schneider had not yet sold its shares in Legrand. The Commission contends that in late November 2002 it informed Schneider that its proposed remedies did not enable the merger to be declared compatible and that an in-depth phase II investigation would be opened once again.

The Commission's argument therefore rests on the missing causal link between the breach of rights of defence in the original 2001 investigation, and the alleged loss arising from Schneider selling its stake in Legrand during the re-investigation following the CFI's annulment. The CFI seems to have overlooked the fact that Schneider had not yet divested itself of its shares in Legrand in October 2002 at the time of the original CFI judgment and the Commission's re-examination of the case.

Policy Implications

The Schneider damages have yet to be quantified, but the total bill could represent a considerable chunk of the Commission's resources, especially as the compensation will also be increased to take account of interest accrued. It will be interesting to see whether the Court takes into account these budgetary implications when it makes its order. Schneider has claimed €1.6 billion in damages – this amounts to well over 1% of the Commission's entire budget.[4]

Looking behind the CFI's reasoning, a broad ruling allowing damages on the basis of error of assessment as well as breach of procedural rights could have left the Commission vulnerable to a number of compensation claims where its analysis is challenged. The result would be a cautious and constrained DG COMP, and such an approach would threaten the effectiveness of the merger control regime.

Furthermore, following the CFI's *Impala* judgment on the Sony BMG merger annulling the Commission's authorisation decision, which implies that the standard of proof is symmetrical for both authorising and prohibiting a merger,[5] it cannot simply clear the transaction where it has doubts. In certain circumstances third parties may have a cause of action themselves, leaving the door open to strategic litigation from rivals in the same market.

A similar damages claim is pending by MyTravel (formerly Airtours) resulting from its wrongfully blocked merger with First Choice. However, that claim is based on the Commission's errors of assessment rather than procedural breaches so may not be successful, given that the CFI rejected Schneider's claims that the Commission had committed other breaches in the merger control procedure.[6] Nevertheless, MyTravel is claiming damages for loss of profits generated by First Choice, which it claims would have accrued to Airtours if the acquisition had not been prohibited; loss of synergy costs savings; and the costs of its abortive bid for First Choice. The CFI's judgment is keenly awaited to see whether or not the Court will broaden the scope for damages claims.

In a wider context, this case raises questions about the appropriate intensity of the Court's supervision in an administrative-led system of competition enforcement. Current research at CCP is investigating the judicial scrutiny of merger decisions in the EC, UK and Germany from a comparative perspective. Applying general principles of judicial review to the field of merger policy, the research will analyse cases in each of the jurisdictions to explain the varying standards of review applied by the courts. One theme is the different roles of specialist tribunals and generalist courts called upon to supervise the decisions of expert administrative agencies, and the extent to which the courts take into account their expertise relative to the agency under review, particularly when it comes to economic assessment. The constitutional context of judicial review is also important: one model is based on controlling public authorities' respect for legality, while another approach is judicial protection of individual rights. This is reflected in the strict standard of review accorded to procedural rights, as in *Schneider*.

[1] Case T-351/03 *Schneider Electric v Commission*, Judgment of the Court of First Instance of 11 July 2007.

[2] Case T-342/99 *Airtours v Commission* [2002] ECR II-2585; Case T-5/02 *Tetra Laval v Commission* [2002] ECR II-4381; and Case T-310/01 *Schneider v Commission* [2002] ECR II-4071.

[3] Paragraph 125 of the judgment.

[4] Thanks to Bruce Lyons for this point. Some have estimated that the award will be nearer to €300 million: 'EC's defeat over Schneider was not a knockout blow', timesonline 26 July 2007.

[5] For a fuller discussion, see K Wright (2007) 'Perfect Symmetry? *Impala v Commission* and Standard of Proof in EC Mergers' 32(3) European Law Review 408-418. Sony BMG's appeal is pending in the ECJ. In the meantime the Commission re-examined the merger and confirmed its unconditional clearance on 3 October 2007.

[6] Paragraphs 127-139 of the judgment.

The Best Things in Life are Free – but the Free Things in Life aren't always the Best

Luke Garrod

Figure 1: *An example of a low-cost carrier's advertisement for a 'free' airline ticket*

There is a growing literature that maintains that firms and consumers are likely to differ in their ability to understand a market in which they interact. Competing firms have an incentive to maximise profits as otherwise they may be forced to exit the market by other profit-maximising firms; whereas consumers face no such pressures. Similarly, the size of the gain from a precise maximisation will typically be larger for firms. Consequently, firms are likely to analyse the market more vigorously than consumers, who perhaps only interact with firms intermittently which may limit their understanding further. Thus, firms may have an incentive to exploit any consumer inaccuracy and attempt to increase errors by obfuscating product information to limit price competition.

However, if consumers are perfectly rational agents, economic theory predicts that competing firms will fully inform consumers of product information if it is feasible and costless. The intuition is that the firm offering the best terms will disclose its product information and consumers realise that any concealment is likely to be unfavourable. However, this prediction is based upon the assumption that consumers have the cognitive ability to infer that they should avoid firms with hidden information, which raises the question: do firms have an incentive to disclose information if some consumers naively visit firms with hidden information?

The Airline Industry

An example where this question is particularly relevant is in the European short-haul airline market where, despite cut-throat competition, firms consistently obscure their prices on the internet by separating them into (observable) base prices and (hidden) taxes, fees and charges (TFCs). In particular low-cost carriers on occasions advertised 'free flights', as seen in Figure 1.

The Air Transport Users Council (AUC) report (2005)[1] believed that airlines used low base prices on their websites to attract consumers who were unaware of firm-specific TFCs until they are a long way into the booking process, at which stage they may not wish to search other firms. Furthermore, there was particular concern about firms' ability to advertise low observable prices as some consumers may not have the cognitive capacity to form correct beliefs about firms' hidden fees. For example:

> *"… passengers might not be aware that different airlines can charge different levels of TFC, even on identical routes … because they assume that TFCs are imposed by a third party and are therefore standard across all airlines operating one route."* [AUC Report 2005, p6]

Thus, the AUC feared some consumers may naïvely purchase flights from airlines with low advertised prices, only to be charged uncompetitive TFCs. It is estimated that this practice of charging consumers unexpected fees towards the end of the booking costs online airline passengers £14 million per annum.[2] Due to this, last year the European Commission passed regulations that require airlines to quote prices inclusive of TFCs to prevent them misleading consumers, and as recently as August, after warning the travel industry earlier this year, the OFT has taken action against 13 airlines that did not include all non-optional costs in price advertisements on their websites.

A Theoretical Model

Recent research at the Centre for Competition Policy has developed a theoretical model that considers the effectiveness of this policy.[3] In the model, firms can set transparent pricing strategies where their prices are common knowledge; alternatively, they can set non-transparent pricing strategies where their total prices include an observable price (which is common knowledge) and a hidden fee, which consumers can discover at some cost. If (all) consumers form correct expectations they fear the worst from non-transparent firms, and so visit the firm with the lowest transparent price. As such, firms select transparent strategies and set marginal cost pricing. However, within the model there are a proportion of sophisticates who form correct expectations, and a proportion of consumers who (naïvely) visit the firm with the lowest *observable* price. Nevertheless, naïve consumers realise their mistake and form correct expectations if they observe a positive hidden fee and can switch at some cost.

The model predicts that market prices are always greater than marginal cost, because for any positive proportion of naïve consumers some firms obfuscate their prices to attract naïve consumers with 'free flights'. Crucially, optimal pricing depends upon transparent firms' incentives to attract naïve consumers after they have been fooled by low observable prices and consider switching. This means competition is most intense when the proportions of sophisticated and naïve consumers are relatively even, which suggests any policies that aim to increase the proportion of sophisticates may actually harm both types of consumers, depending on their relative size before the implementation of each action.

Furthermore, firms have no incentive to set transparent prices (to the detriment of consumers) unless effort cost is above some threshold. Therefore, a policy that assists consumers to search the market more effectively can also *increase* prices in some situations. This suggests that the European Commission was correct to pass regulations that require airlines to set prices inclusive of taxes, fees and charges, because this will be the most effective policy as complete transparency will render consumers' naïvety irrelevant and competitive forces reduce prices to marginal cost.

[1] AUC Report (2005) "Taxes, Fees and Charges: An AUC Report on Pricing on Airlines' Websites", available at: www.auc.org.uk

[2] OFT (2007) "Internet Shopping", An OFT Market Study, June 2007.

[3] Garrod, L. (2007) "Price Transparency and Consumer Naivety in a Competitive Market", CCP Working Paper 07-10.

Efficiency Pass-Through and Horizontal Mergers

John Ashton and Khac Pham

When competition law authorities judge the benefits of mergers, the degree to which market power may be raised and competition reduced is of primary importance. A key element is determining whether the merger will positively influence the firms' operating efficiency and benefit the customers involved. Theory which has considered this relationship between efficiency and prices within mergers has provided generally conservative predictions. For example Farrell and Shapiro[1] suggest most mergers will result in adverse conditions for consumers when efficiency gains are not present, and relative price improvements occur only when substantial efficiency gains are recorded after a merger. Most empirical assessment to date has only considered efficiency and price effects of mergers separately, indicating efficiency gains from mergers are often inconsistent[2] and price changes are generally poor for customers.[3] A recent study conducted at the ESRC Centre for Competition Policy examines both these related efficiency and pricing effects by considering 61 horizontal bank mergers occurring in the UK retail banking sector between 1988 and 2004.

Within the study undertaken by John Ashton and Khac Pham,[4] the cost efficiency of over 100 UK banks and building societies, representing the majority of this sector, is initially assessed. Cost efficiency is quantified through estimating the characteristics of the relationship between banks' operational and financial costs and the input prices of funds, staff and capital investment and the output quantities of the bank, including loans and securities. This cost function, estimated as a stochastic frontier, is used to determine the annual bank-specific levels of cost inefficiency for both merging and non-merging banks.

Then, the relative change in interest rates for banks which have merged over the sample period is assessed. This procedure, using a regression equation, ascertains whether a merger has a significant influence on the change in interest rates for instant and notice deposits, and unsecured and mortgage lending. The data for this assessment, provided by Moneyfacts plc, is recorded monthly for the individual banks for a number of different quantities borrowed and deposited. This assessment is undertaken for two years before, and six years after, a bank merger to accommodate concerns that mergers involve long-term changes.

The UK retail banking market is populated by a small number of major banks and a large fringe of smaller banks and building societies. Mergers within this sector are mostly between small institutions, particularly mutually-owned building societies. Generally the target bank is much smaller than the acquiring bank and some have been involved in a number of different mergers. Only a few very large mergers which might be expected to strongly influence market power were recorded in this study. Subsequently the influence of the sample mergers on market power within this national market[5] is deemed to be limited in most cases.

Three key findings of the study emerge. First, UK retail bank mergers between 1988 and 2004 have led to significantly enhanced cost efficiency for the merging banks. This improvement continues for the six years after the event, demonstrating that the merger has had long-term positive efficiency effects.

Second, retail interest rates for most banking services are not significantly influenced by mergers. This is consistent for both savers and borrowers of larger and smaller monetary quantities. Subsequently we can indicate that despite the considerable cost efficiency gains appreciated by banks and building societies, these benefits are not forwarded to all consumers.

Third, notice deposit accounts were significantly and negatively influenced up to five years after merger. Prior to merging, target banks, on average, offered notice accounts with relatively attractive rates of interest, particularly for smaller monetary quantities. In the years after a merger significantly poorer rates of interest on notice accounts are recorded, particularly for savers of larger quantities. This change is indicative of a wider shift in product provision away from notice accounts, a process clearly accelerated by the merger of separate banks. Bank mergers in this case disadvantage one group of customers whilst leaving the situation of other customers unchanged.

To summarise, the duration over which efficiency and price changes occur after mergers is substantial and the effect of mergers on different products varies. These findings raise a significant question for the regulatory assessment of mergers. Historically the impact of mergers was assessed through a proxy such as market share (see Werden 2002)[6] to quantify the effects of mergers on market concentration and, by implication, market power. Where an increase in market power is not substantial, concerns as to the potentially adverse effects of mergers on consumers persist. These findings also indicate that the price and efficiency effects of mergers may not be clearly understood through assessment of market share change alone. Indeed to comprehend more fully the impact of mergers, investigation of possible differential pricing and efficiency effects is required in addition to these traditional approaches.

This recommendation is also consistent with recent Competition Commission practice. For example the examination of the merger between Lloyds TSB and Abbey National was expected to display substantial efficiency gains. This merger was blocked as the competition authority, amongst other reasons, stated these efficiency gains would not be passed on to customers.[7] In light of our findings, this approach of considering the efficiency and price effects of merger, in addition to examining concentration changes, appears insightful.

[1] Farrell, J. and Shapiro, C. (1990). "Horizontal Mergers: An Equilibrium Analysis", *American Economic Review*, 80(1), pp.107-126.
[2] See Amel, D., Barnes, C., Panetta, F. and Salleo. C., (2004). "Consolidation and efficiency in the financial sector: A review of the international literature", *Journal of Banking and Finance*, 28(10), pp. 2493-2519.
[3] For example Focarelli, D. and Panetta, F. (2003). "Are Mergers Beneficial to Consumers? Evidence from the Market for Bank Deposits", *The American Economic Review*, 93(4), pp.1152-1172.
[4] Ashton, J. and Pham, K. (2007) "Efficiency and Price Effects of Horizontal Bank Mergers", CCP Working Paper 07-9.
[5] The market definition of the UK banking sector displays characteristics of national market, yet also contains certain regional influences. The assumption of national markets in this context is a strong yet not implausible assumption.
[6] Werden, G. J. (2002). "Assigning Market Shares", *Antitrust Law Journal*, 70, pp. 67-104.
[7] Competition Commission. (2001). *Lloyds TSB Group plc and Abbey National plc: A Report on the Proposed Merger*, CM 5208, London.