

BS2243 – Lecture 11

Regulation and deregulation

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Antitrust laws – key points

- The interpretation of (US) antitrust laws varies over time.
- Antitrust laws should promote efficiency.
- Monopoly is not prohibited, but certain activities that can lead to a firm's acquiring or exercising monopoly powers are banned.
- Price fixing is generally prohibited.
- Certain agreements among competitors, vertical relations between firms, and various other strategic acts may increase or decrease welfare; hence, they should be evaluated on a case-by-case basis.
- A few antitrust laws, such as the prohibition on price discrimination that allegedly reduces competition among companies, almost always lower welfare.
- Prohibiting certain activities and not others can lead to inefficient organisation of firms.

What does the UK law say?

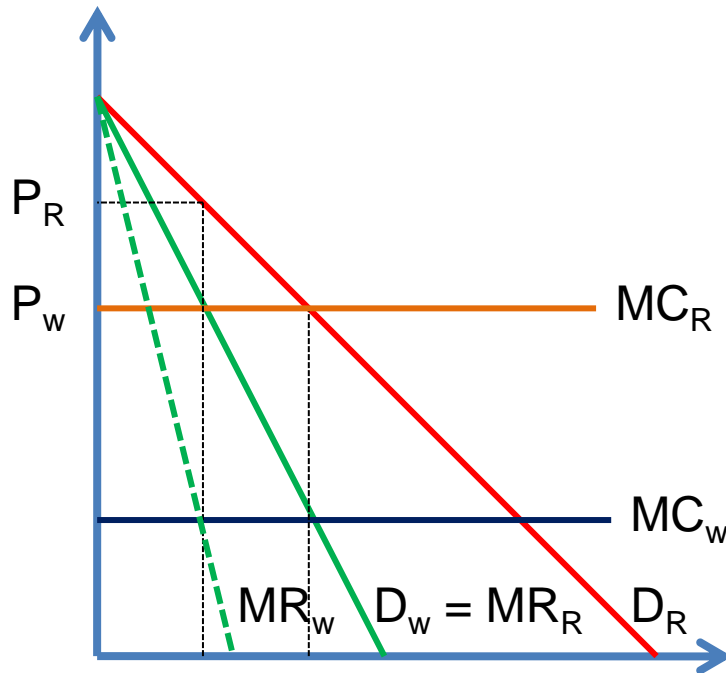
- Competition law prohibits almost any attempt to fix prices - for example, **you cannot**:
 - **agree prices** with your competitors, e.g. you can't agree to work from a shared minimum price list
 - **share markets** or limit production to raise prices, e.g. if two contracts are put out to tender you can't agree that you'll bid for one and let your competitor bid for the other
 - impose minimum prices on different **distributors** such as shops
 - agree with your competitors what **purchase** price you will offer your suppliers
 - cut prices below cost in order to force a smaller or weaker competitor out of the market
- The law doesn't just cover formal agreements. It also includes other activities with a **price-fixing effect**. For example, you shouldn't discuss your pricing plans with your competitors. If you then all 'happen' to raise your prices, you are fixing prices
- The law is enforced by the OFT, which can impose a **fine** of up to 10 per cent of your turnover. It can also apply for company directors to be disqualified

Source: <http://www.businesslink.gov.uk>

The US legal environment

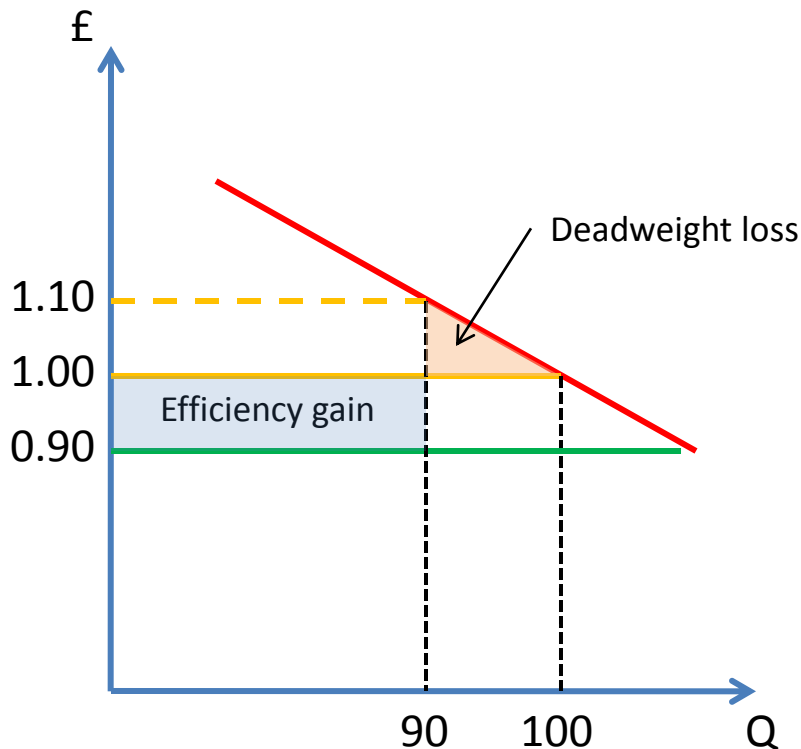
- Common law
 - Price fixing among firms not illegal but unenforceable in court
 - Agreements not to compete that accompanied sale of businesses also unenforceable if deemed “unreasonable”
 - Practices like predatory pricing not illegal unless accompanied by fraud
- Sherman Act (1890)
 - Explicitly forbids cartels
 - Monopoly not a crime so long as it does not commit “bad acts”
- Clayton Act (1914)
 - Prevents price discrimination that reduces competition
 - Prohibits tie-ins and exclusive dealing when they reduce competition
 - Prohibits mergers that reduce competition
 - Addresses interlocking directorates among competing firms
 - Allows the “injured” party three times actual damages plus attorneys’ fees

Are antitrust laws efficiency enhancing? - I



- Demand curve for product (and hence for retailer) = D_R
- Wholesaler knows that retailer uses the MR curve to decide on output, and hence $D_W = MR_R$
- Wholesaler charges price P_W which then is the MC for the retailer
- Price for the consumer is P_R
- In the case of vertical integration, price would have been P_W

Are antitrust laws efficiency enhancing? - II



- Merger outcomes:
 - Price raised from £1 to £1.10
 - MC (= AC) declines from £1 to £0.90
- Implications:
 - Deadweight loss = $0.5 \times 0.10 \times 10 = 0.50$
 - Efficiency gain = $0.10 \times 90 = 0.90$
- In general, efficiency gain is more likely to dominate if the output level sold in the market is large
- Regulations generally take a dim view of price rises following mergers even if there are compensating efficiency gains
 - Conflicting views of US and European regulators about GE-Honeywell merger

Challenge I – estimating market power

- Market power
 - Definition: $(P - MC)/P = 1/\varepsilon$, where ε is the elasticity of demand
- Problem
 - How can we estimate ε of the firm created by mergers between two firms?
- Rule of thumb
 - Compute HHI before and after merger
 - (a) If initial HHI less than 1000, merger is deemed unproblematic
 - (b) If initial HHI is 1000-1800 and HHI increases by 100, merger is deemed problematic
 - (c) If HHI is greater than 1800 and HHI increases by 50, merger is deemed problematic

Challenge II – estimating extent of market

- Are Coke and Fanta in the same market? Is tea?
- Estimating the extent of the market requires the identification of all demand and supply substitutes
 - Product B is a *demand substitute* of Product A if a rise in the price of A increases the demand for B
 - Product C is a *supply substitute* of Product A if a rise in price of A makes a firm switch from production of C to production of A
- Rule of thumb
 - Decide whether two products are in the same market either by interviewing producers or by checking correlation between their prices
 - More often than not, the (own) price elasticity – and not the cross-price elasticity – is taken into account to decide whether or not a firm has market power

Are all agreements among competitors bad?

- Price fixing and output agreements
 - Price fixing and output fixing are fundamentally in violation of antitrust laws
 - The court does not need to undertake additional inquiry about the “reasonableness” of these actions to deem them to be illegal
 - However, courts do take into consideration the question as to whether price fixing in specific cases might promote competition in some way
- Information exchange among competitors
 - An important consideration is whether the group of firms exchanging information is small enough to effectively form a cartel
- Oligopoly behaviour
 - Similarity of behaviour (e.g., with respect to pricing) is deemed unacceptable
- Mergers
 - Mergers among competitors (and even among potential competitors) generally not allowed
 - However, courts do entertain the *failing firm* defence of such mergers

Status of other strategic behaviour

- Case of *Alcoa*
 - Exclusive supply contracts with power companies
 - Price-fixing with foreign firms to reduce import competition in the USA
 - Selling aluminium at higher prices to producers of aluminium sheets
 - Expanding capacity
- Contrast: Case of *Kodak*
 - Did not pre-disclose its 110 film format to rival company
 - ⇒ Pre-disclosure is not required under anti-trust laws, and the resultant monopoly is not necessarily unacceptable
- Predatory pricing
 - Is a product priced below its production cost?
- Refusal to do business with a rival
 - Is the product/service being denied essential for the survival of the rival?
- Vertical integration and vertical restraints (e.g., MRP, exclusive territories)
 - Might also involve cross-ownership of shares (e.g., Du Pont taking 23% stake in GM)
- Tie-in sales

The case of the US banking industry

- National Bank Act (1864)
 - Banks have to be chartered (licensing)
- McFadden Act (1927)
 - Required national banks to restrict branching to the state in which they were located
- Glass-Steagall Act (1933)
 - Separated commercial banking from investment banking (economies of scope)
- Regulation Q
 - Prohibited banks from paying interest on demand deposits (and imposed interest rate ceilings for savings accounts)
- Foreign Bank Supervision Enforcement Act (1991)
 - Federal Reserve must approve the entry of all foreign banks
 - Bars branches of foreign banks from accepting deposits of less than \$100,000 from US residents and citizens
 - Fed must be notified if a foreign bank owns 5% of a US bank; and Fed must approve foreign parent bank as a holding company if it owns 25% of a US bank