



The Economics of Competition: A European Perspective

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Theme 3:

Competition, Regulation and Privatisation

Chapter 6

An Introduction to Privatisation and Regulation

6.1. Introduction

This chapter introduces some of the main debates and trends associated with privatisation and regulation. Interestingly, whilst the emphasis on privatisation would suggest lower levels of state intervention it has led to the creation of a different set of regulatory tools to control potential anti-competitive abuses by these new privately owned firms. De-regulation has been associated with re-regulation (Majone, 1999). The next chapter shows privatisation requires an all-encompassing definition because it indicates greater use of the market in once publicly owned and controlled activities. However, public utilities are the focus of this chapter partly because they have produced the largest revenues from privatisation since the practice took on its most recent form. Public utilities are characterised as having a natural monopoly element through the existence of a (usually) national network and provide services that are deemed as having few substitutes, i.e. they are necessities that are inelastic in demand. In addition, the regulatory framework associated with public utility privatisation, such as telecommunications, gas and electricity, has given birth to a new and powerful breed of sectoral agencies with quite substantive powers of intervention.

This brief chapter sets out to

- Explore the rationale for state ownership and the benefits of privatisation.
- Examine the trends in privatisation
- Consider the inter-relationship between regulation and market structures, notably the move from regulation to more competitive environments
- Question the implicit criticism of privatisation, namely that public ownership is inefficient.

6.2. Privatising Public Utilities

Competition policy covers all sectors of the economy, public and private, agriculture, manufacturing and tertiary. It is also very insistent on examining private and public monopolies. However, the case of a 'natural monopoly' has always warranted a sympathetic approach by competition regulators. The rationale for this is fairly straightforward. It represents a situation where it is economically sensible for one firm to provide a networked service such as gas or electricity than two or more firms. In such circumstances regulators have to protect the natural monopoly from inefficient entry only interested in 'cream skimming' the market for short term gain. The natural temptation for 'natural monopolies' to live up to the latter part of their name and raise prices required control too. Though the huge sunk cost element embodied in public utility networks meant that prices could not be equated with marginal cost, if appropriately managed prices could be kept in line with average costs. The best way of doing this, it was argued, was via state ownership. Other factors were also noted as relevant in the desire for state ownership of public utility networks (see Waterson, 1988). For example, the socialist tradition of controlling the means of production, distribution and exchange. Likewise by coordinating activities such as coal, rail and electricity generation proponents of state ownership of public utilities noted the opportunity to develop a national planning regime. Similarly the desire to facilitate redistribution objectives via public utilities, such as lower fares for particular groups or a universal service obligation, or to facilitate some

positive externalities by, say, moving freight transport from the roads to the rail network provided other good reasons for state ownership.

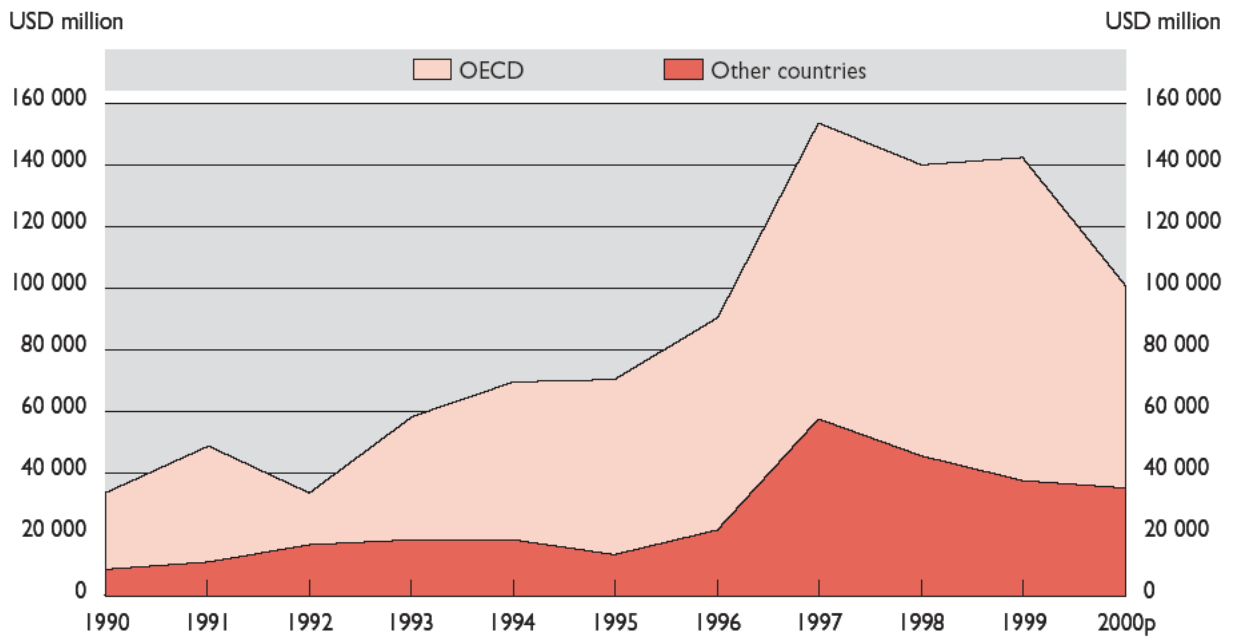
However, it was the natural monopoly argument that was seen to dominate all others (Vickers and Yarrow, 1988). In the UK the inefficiencies in state run enterprises were being exposed by conservative politicians, most forcefully by the then Prime Minister, Mrs Margaret Thatcher, and by the upsurge in economic thought represented by the public choice and property rights schools (see chapters 4 and 7). In addition there was the rise of contestable markets theory which questioned the very existence of natural monopolies (see Baumol et al, 1982). A good example is that of telecommunications. Before the 1980s it had been thought that only one firm should supply a range of telecommunications services rather than two or more firms. However, contestable markets theory suggested that changes in demand and costs could lead to a new industry structure. There could, for example, be competition in long distance calls and as technology changed new types of operator came into the market supplying both cable and mobile telephony systems.

Such a challenge led to a widespread effort to transfer assets or control over assets from the public to private sector in what became known as privatisation. In addition to the theoretical challenges mounted against state ownership of assets there were a number of pragmatic reasons (Shelton, 2001). First, privatisation can contribute enormously to public finances, a point echoed by Figure 6.1 of which more will be said below. Second, a private entity has a greater ability to raise the funds needed to expand and modernise. Third, privatisation can help create a broader, deeper national capital market. This is a benefit that could be particularly important to developing countries. Fourth, privatisation helps promote a “culture of efficiency” in many countries’ public enterprise sectors. It contributes to the creation of a competitive market for managers within the state owned sector, as well as between it and the private sector. Fifth, the management of privately owned enterprises is subject to the discipline of the marketplace if it fails to operate efficiently. Finally, in addition to the economic reasons why countries around the world are engaging in more and more privatisation, there is also a political one. Private ownership of production tends to support democratic institutions, because it results in shared power, whereas public ownership tends to concentrate both political and economic power in the same hands.

6.3. Trends in Privatisation

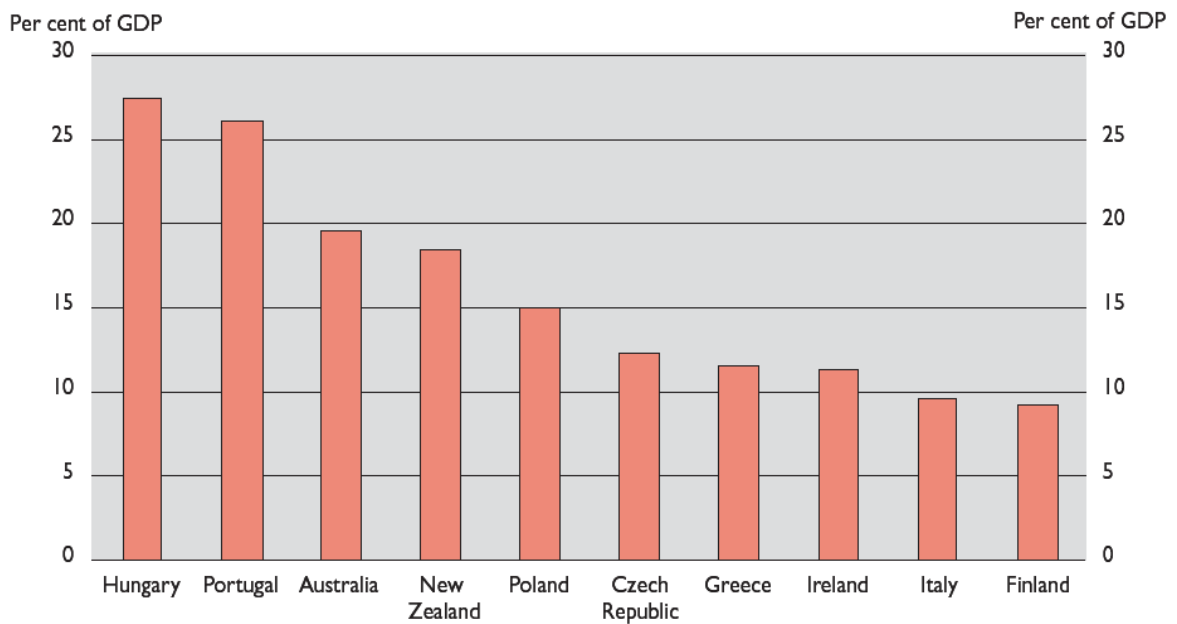
Figures 6.1 to 6.3 show clearly that privatisation has had a considerable effect on the revenues, GDP and industrial structure of both OECD and non-OECD nations, though the former have seen most change. Throughout the 1990s the largest revenues were attributable to the European Union countries, averaging 45% over the decade and this excludes a large portion of UK privatisation revenues, which were realised in the 1980s. Privatisation revenues are important to non-OECD countries too. These accounted for 30% of total privatisation revenues in the 1990s. The trend is demonstrably upwards though in the latter years of the 1990s the downturn was attributable to difficulties in equity markets, particularly in the technology and communication sector, the south east Asian crisis and the diminishing inventory of state owned assets available for privatisation reflecting the maturity of the programme in many countries.

Figure 6.1. Global amounts raised from privatisation



Source: Mahboobi L (2001)

Figure 6.2. Total privatisation proceeds relative to the size of economy in selected OECD countries 1990-2000p



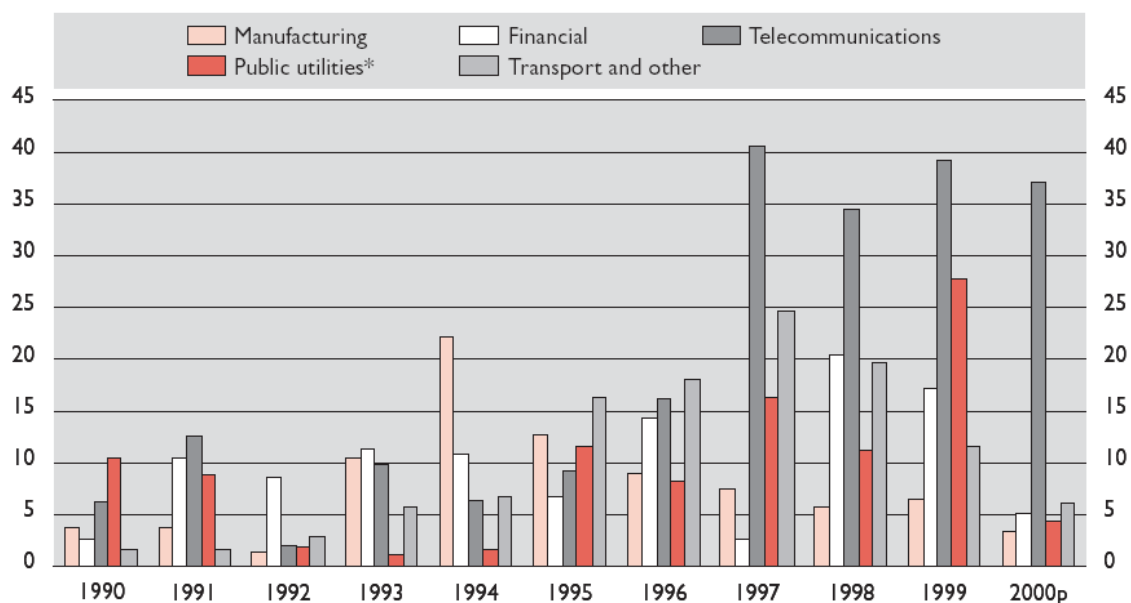
Source: Mahboobi L (2001)

The OECD's cumulative privatisation proceeds reached 3% of the areas GDP, the bulk of which was raised in Italy, Australia, France, Spain, Portugal and the UK. However, the impact was probably largest on small countries such as Hungary and Portugal where it raised over a quarter of their GDP (see Figure 6.2).

Figure 6.3 shows clearly that most privatisation impacts upon the public utility and telecommunication sectors (although the disaggregation seems to have been undertaken to demonstrate the importance of revenue raising from telecommunications). There have been some big privatisations in the electricity and transport (notably of airlines) sectors in recent times in OECD countries.

Similar broad trends can be depicted in non-OECD nations with public utilities, including telecommunications, have realised the lions share of revenue. However, privatisation of manufacturing and more recently financial institutions has made an impact on revenues. There are also some local variations. For example, Brazil, China and Russia raised substantial amounts from sales in the oil and gas sector.

Figure 6.3. Privatisation in OECD countries by main sector
US Dollars billion



*Includes electricity, gas and water.

Source: Mahboobi L (2001)

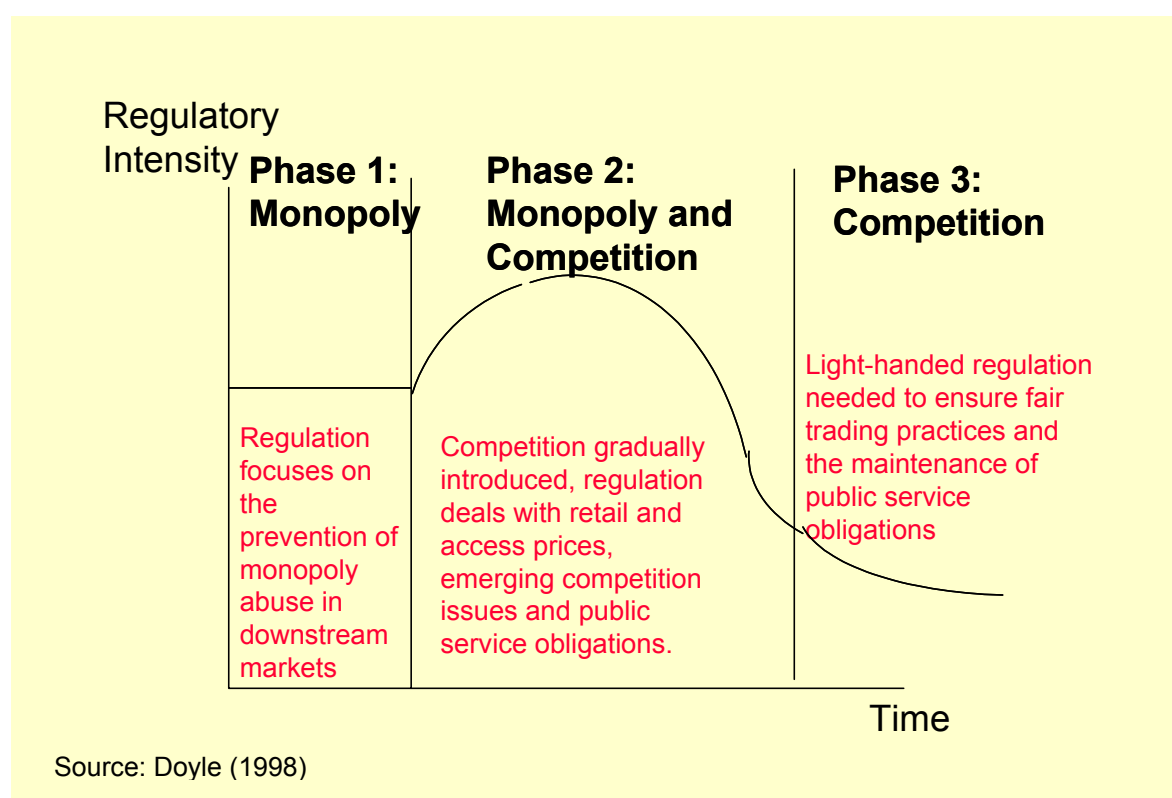
Most of the OECD privatisations have been via public offerings to small shareholders. There has been very buoyant demand for such sales though many countries have also taken the mixed route of offering ownership by trade sales as well as sales to the general public. The advantage of mixed route is that it allows wide ownership of shares and allows those with direct corporate experience to engage in enhancing the efficiency with which the privatised firm is run. The disadvantage is that corporate buyers may feel under-represented in the development of the privatised company and thus have a more limited impact.

The experience in non-OECD countries where wealth inequalities are more apparent is sale by private offering to large corporate buyers, at least in the latter part of the 20th century. This

enhances the transfer of ownership and may lead to improved governance because of the experience that corporate buyers bring to a once state-run firm.

6.4. Regulatory phases

Once in private hands regulators must ensure that once public monopolies do not become private monopolies. New regulatory bodies must be put in place to ensure that anti-competitive practices do not develop. Doyle (1998) notes three phases to the regulation of privatised utilities and these are outlined in Figure 6.4. The first phase represents a transfer of a utility from a public to a private sector firm largely as a monopoly. Here regulators must ensure that monopoly power does not result in higher prices for consumers, as would be the case in a theoretical monopoly case. In the UK the preferred form of regulation was called RPI minus 'x' (see Vickers and Yarrow, 1988, for a more detailed discussion of this). That is privatised utilities were not generally allowed to raise their prices by more than the retail price index (the general inflation rate) minus some 'x' factor determined by the regulator to promote efficiency. So, if the RPI was 3% and the required 'x' factor was 5%, privatised utilities had to provide services with a real fall in prices of 2% until the end of the regulatory period. This has raised a number of issues, notably about the value of the 'x' factor and the timing of the regulator's price control.



These issues relate largely to the problem of information asymmetry between the regulated and the regulator. Privatised monopolies are unlikely to reveal information they deem to be confidential to a regulator and public utility regulators are unwilling to discuss future plans for the industry with an incumbent in case it deters potential entrants at a later date. Both have separate objectives: the former to maximise economic profits by maintaining control over its network, the latter to maximise social welfare by moving the process of regulation forward to phase 3 – 'competition'. Trust between the two parties can be difficult to establish in such circumstances. Strategic posturing develops as new regulatory controls are introduced.

A key issue in phase 2, where monopoly and competition co-exist, is ensuring that new competitors can access public utility networks at fair prices. Such a move requires that initially there is transparency in access prices to the network and ultimately that the network element is divorced from other related activities of the privatised firm. Without this an

incumbent privatised monopoly owner of (say) the (gas pipe) network who had ownership over substantial downstream (gas) distribution could charge potential competitors monopoly prices to access the network and so retain control over a large share of the (gas) market to the detriment of customers (see Armstrong *et al*, 1994).

It is interesting to note that in the UK privatisations of public utilities the government changed the pattern of industry structure over time. For example in the sale of Gas (1986) the government transferred the companies from the public to the private sector largely as monopolies. However, as privatisation evolved the resulting industry structures changed so that by the time the railways were sold to the general public the natural monopoly network was vertically separated from access to use the network. Such a change required a repositioning of the regulatory regimes associated with previous privatisations. Ownership of the gas network became separated from competition to use the network. Indeed, many companies now supply across the network and many of them also provide electricity. The early experiences of the UK privatisation have led the OECD to suggest that future privatisation of utilities involves separation of the sunk costs associated with the network with competition for network use, although there may be numerous ways to do this (OECD 2001)

Once transparency and access have been established and barriers to entry are minimised, phase 3 in the privatisation process involves developing competition. Here the role of the regulator is to ensure that any remaining potential abuses by dominant players in the market are avoided by ensuring industry participants engage in fair trading practices. In addition, as customers see public utilities as necessities, regulators have to ensure that public service obligations are met. For example, that sufficient rural postal and telephone services are provided or that low-income groups such as pensioners have concessionary schemes.

6.5. Is there no role for the State?

To finish this brief chapter it is necessary to address on implicit criticism associated with privatisation, namely that the state is inefficient in the provision of public utilities, or indeed, other services. However, it is partly necessary to distinguish between productive and social efficiency. Clearly, state ownership implies different objectives to that of the private sector. Interestingly, even on productive efficiency grounds the evidence that public sector firms are worse than private sector firms in the running of utilities is a little mixed (see Ferguson and Ferguson, 1994). This is partly due to the impossibility of comparing like with like though, on balance, Ferguson and Ferguson (1994) prefer to argue that 'ownership matters' and that private is best. The argument is ultimately judgemental because there are no appropriate counterfactuals. In fairness to public sector managers they are accountable to independent watchdogs, the press, their peers in the labour market and, of course, to the electorate.

Activity

Privatisation of public utilities has been pervasive in many countries and so too has the issue of separating networks from other activities. Your task is to download the following OECD policy brief

Restructuring Public Utilities for Competition (2002) available at <http://www.oecd.org/pdf/M00026000/M00026489.pdf>

And consider these questions

What are the benefits and costs of vertically separating public utilities?

Should it be done?

Put your brief answers on the discussion board

Reading

Armstrong M, Cowan S & Vickers J (1994) *Regulatory Reform. Economic Analysis and British Experience*. MIT Press, London

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Chapter 7

UK Privatisation and the Region: Lessons and Opportunities for Policymakers

This is a paper I wrote in 1999 that was subsequently published in Targalskiego J ed., (1999) *Przedsiębiorczość a lokalny i regionalny rozwój gospodarczy*, Akademii Ekonomicznej w Krakowie, Krakow.

Abstract

This paper uses four case studies to show the spatial impacts of UK privatisation upon the regions; namely, Compulsory Competitive Tendering, the closure of a merchant shipbuilding yard, bus deregulation, and the utilities sector. The cases examine labour relations and redundancy, as well as competition and regulatory challenges for policy makers. There are a number of lessons to be learnt. First, privatisation has impacted dramatically upon labour relations and increased human misery for those made redundant. An incremental approach, which acknowledged spatial issues along with a sensitive economic development package, would have softened the impacts. Second, a strong regulatory framework that incorporated sector-specific and local controls would have reduced anti-competitive behaviour in bus markets. Third, the acknowledgement of natural monopoly elements associated with utilities may have led to a spatially decentralised industry structure rather different to that which the UK has today.

Privatisation has had a long history in the UK and so it is important to look forward. This paper argues that the regional regulatory input and strategic focus of transport and utility provision is weak at present and there are important reasons why this should change. The labour administration's favourable attitude to regional government and its current review of transport and utility regulation may provide a catalyst for future development.

7.1. Introduction

In 1979 the UK Conservative Prime Minister, Mrs Thatcher, announced that she would 'roll back the frontiers of the state' and provide greater opportunity for the private sector. In doing so she launched privatisation, a policy that, subsequently, has been emulated by governments across the globe. Broadly defined, privatisation refers to the processes by which assets or activities owned and controlled by the public sector are subjected to market forces. These include the transfer of assets to the private sector by share flotation or private sale; the deregulation of markets; and the competitive tendering for activities once carried out solely by public service organisations.

Privatisation impacts upon product, labour and capital markets. Most assessments at the national or industry level rely on aggregate or highly specific data to examine issues and are largely spatially detached. Regional and local impacts are typically appraised by a single case study method because insufficient data prohibits wider analysis. Case studies have been seen therefore as parochially interesting but dismissed, as, unlike the national and industrial studies, they do not inform the wider policy debate determined by national government. However, the longevity of UK privatisation has led to a plethora of case studies from which it is possible to examine emerging trends and common policy issues for regional communities. This paper uses four case studies to demonstrate the pervasiveness of the impacts across space. Two of the case studies - Compulsory Competitive Tendering (CCT) for local government services and the closure of a shipyard - examine employment issues.

They are based upon research that the author has been involved in during the 1990s and illustrate the need for sensitive handling of labour relations and redundancy as well as the spatial dynamic created by policy changes. The other two case studies - the utilities sector and the bus market - examine competition and regulatory challenges, which are of vital importance for the region. Collectively, these studies provide lessons about policy implementation.

The following section examines selected insights of the privatisation process. A discussion about the theory of privatisation and the regional implications follows. The cases are then examined. A conclusion completes the paper.

7.2. The privatisation process

Table 7.1 provides selected insights as to the pace and scope of the policy under the successive conservative administrations of Margaret Thatcher (1979-91) and John Major (1991-97). Privatisation is divided into four main categories. Compulsory Competitive Tendering (CCT) for particular services was the main, but not the only, method of privatisation applied to local authorities, central government and health care providers. By doing this, Conservative governments were questioning the efficiency and boundaries of monopoly public service providers. The 'traditional industries' of steel, coal mining and shipbuilding have also been affected by privatisation. Throughout the 1980s they underwent dramatic capacity rationalisation largely due to industrial relations problems and the government's belief that public subsidy levels were too high. British Steel was 'floated off' by public share sale in 1988. A large firm that operated in a competitive market, the dramatic rises in productivity in the previous years made this a prime candidate for a successful privatisation (Parker and Wu, 1998). Merchant shipbuilding and coalmines, when much diminished, were sold to private buyers. The privatisation of the former in 1988 led to a closure of North East Shipbuilders in Sunderland over the next three years, a case study which is examined later in this paper. The final publicly owned pit was sold in April 1995. Privatisation has also required the deregulation of markets. This has been pervasive throughout the period; facilitating further competition pre-privatisation (as in the opening up of the telecommunications market in 1981) and post-privatisation (when regulation has been failing, as in the gas market) as well as to allow privatisation where contractual regimes are deemed inappropriate (as in the case of buses). Perhaps the most prominent feature of the privatisation programme was share floatation that characterised the sale of the larger publicly owned enterprises that operated in competitive markets as well as the monopolised utilities sector. Share sales proved a ballot box success. They were massively over-subscribed, suggesting discounted prices, and those who could afford to buy saw their wealth dramatically increase. Private sales and management buy-outs of smaller publicly owned enterprises in competitive environments proved equally cheap and popular.

The election of a labour government, a democratic socialist party, in 1997 has not led to a re-nationalisation of public utilities; it would be prohibitively expensive. Likewise effective local and central government still has to acknowledge the importance of market forces. What the labour government has done is work with the inevitable forces associated with the privatisation 'steamroller' by slowly adapting the regulatory regimes. Thus, there is an acknowledgement that privatisation over the past twenty years has irrevocably changed the nature of government provision and its legacy will be with us for many years to come.

Table 7.1: Selected Developments in the UK Privatisation Programme, 1979 to 1997.

Period	CCT	Traditional Industries	Deregulation	Public Utility Share Floatation and other private sales
1979 to 1983	1980 Local Government Planning and Land Act which subjected local government highway and building maintenance and construction activities to Compulsory Competitive Tendering (CCT) with private sector rivals.	Continued rationalisation in merchant and war ship building, coal and steel	1980 Road Transport Act abolished road service licences as a condition of running a coach service. The British Telecommunications Act, 1981, ended British Telecom's (now BT) monopoly in equipment supply and provided for some competition in network services.	<i>Sales of Enterprises operating in competitive Markets:</i> Associated British Ports (port operations), British Aerospace (aircraft and defence contracting), Britoil (North Sea oil exploration and production), Cable and Wireless (telecommunications operations), National Freight (road haulage), and sales of stock in British Petroleum (already part privately owned).
1983 to 1987	CCT introduced to the ancillary services, catering, cleaning and laundry, in UK hospitals (1983).	Further rationalisations in the 'traditional' publicly-owned industries of coal, shipbuilding and steel.	The 1985 Transport Act led to full scale bus privatisation in local markets.	British Telecom (1984) and British Gas(1986) transferred to the private sector. Some competition for BT with a rival, Mercury, in trunk and external (overseas) telephony. Very limited competition in business gas supply; monopoly provision on domestic gas. Abuses of market power were to be controlled by regulators, the Office of Telecommunications (OFTEL) and The Office of Gas Supply (OFGAS). <i>Sales of Enterprises operating in competitive Markets:</i> Enterprise Oil (oil exploration and production), Jaguar (motor cars), The Trustees Savings Bank, British airways and Rolls-Royce (aeroplane engines).
1987 to 1992	The 1988 Local Government Act of 1988 required local authorities to put a number of 'blue collar' services out to tender; refuse collection, street and building cleaning, grounds and vehicle maintenance, catering services and sports and leisure management. Purchaser-provider splits also began to develop especially in the provision of health services. Local hospitals began the process of becoming independent public bodies, or trusts They provided health services to purchasers - district health authorities and general practitioners.	Share Floatation of British Steel (1988). Closure of North East Shipbuilders, Sunderland and sale of the Govan Yard marks the end of publicly owned merchant shipbuilding in UK. (1988 - 91)	The Telecommunications Duopoly of BT and Mercury is ended (1991) and other fixed link operators are licensed. Also developments in cellular phones.	Water Privatisation (1989). Ten regionally based 'water and sewerage companies' in England and Wales were floated on the stock exchange and some twenty nine privately owned 'water only companies' were granted licences by a new regulator, OFWAT. An unusual feature of the new regime was that prices were to increase by an amount in line with inflation plus a factor, K, to meet new capital spending on infrastructure. European Commission legislation on the environment also raises prices. Electricity privatisation (1990) involves vertical separation of generation, from transmission, distribution and supply. At the regional level, domestic and, to a large extent, industrial customers were faced initially with Regional Electricity Companies who were monopoly suppliers regulated at the national level by The Office of Electricity Regulation (OFFER).
1992 to 1997	CCT in local government was extended to 'white collar' functions such as finance, computing, personnel and legal services and housing management (Implemented from 1996). The Civil Service, which has important representation in a number of regions, were to begin a programme of 'market testing' in 1991, which required government departments (and their agencies) to put out a quota of their services to tender.	Energy review (1992) leads to closure of 31 out of the 50 remaining pits creates further problems for coal mining communities. Remaining 'Super-Pits' sold to the private sector. Final sale 1995.	Further developments in gas regulation have led to the divorce of the gas network from the supply of gas (1996). British Gas is de-merged and two separate companies are formed: BG, which owns the network and Centrica, which supplies gas to the home. Competing suppliers can now pipe gas into homes and businesses over the network. Regional Electric Companies (RECs) allowed to supply gas by 1998. REC monopoly of domestic electricity supply to be ended. (1999)	Railway privatisation (1993) involved the divorce of track and earthworks (stations, tunnels, bridges, etc) from use by trains. A single company, Railtrack, now owns the network whilst routes and timetables were divided into 25 separate franchises based on British Rail's former activities both by sector and geographical region. A total of 13 private companies were awarded these franchises and a rail regulator (ORR) oversees the process of competition. British Energy, a provider of nuclear power, sold off in 1996 and becomes subject to regulation by OFFER.

7.3. Privatisation Theory and the Region

Although a number of reasons for privatisation have been mooted its over-riding purpose was to reduce perceived inefficiencies in the delivery of publicly owned goods and services. This 'productive' inefficiency case centres on two arguments. First, that agents of publicly owned activities are motivated by self, rather than public interest. Politicians are seen as vote-maximisers and thus seek personal objectives consistent with electoral success. Civil servants are seen as contributing to this process by justifying existing bureaucracies or even expanding them in the pursuit of personal prestige. Second, an absence of well-defined property rights in publicly owned activities leads to managerial inefficiency. For example, unions recognise that public sector managers would pay wages in excess of productivity because, with non-existent capital markets, asset values could not be depressed as in the private sector firm. These arguments suggest that productive inefficiency naturally exists in public sector activities and that taxpayers bear the burden for over-manning and excessive wage payments. Further, the process of privatisation had political roots for those on the 'right wing' of the conservative party had a natural antipathy toward local government and trade unions. Against such a background, it is unsurprising that the government privatisation agenda focused upon public service delivery and the traditional industries.

The change in objective away from public subsidy and toward the market has created tensions in labour relations within organisations undergoing the transformation caused by privatisation. Haskel and Szymanski (1994) further note that such a process lead to falling wages and falling employment across all sectors. For individuals unemployment, or the prospect of unemployment, involves the greatest psychological costs (Oswald, 1997).

Privatisation was therefore likely to generate industrial relations problems for those organisations involved in the privatisation process as well as social distress. These impacts would also vary across space. CCT for public services and health care was a national policy but variations across locations should be anticipated because of the heterogeneous nature of the organisations involved. Thus, the type and size of the organisation, as well as the distance of the organisation from potential competitors would influence the spatial distribution of employment impacts. If potential competition is illusory in some locations, because information about commercial opportunities declines with distance, then CCT is a questionable national policy. Further, the industrial relations impacts may be even greater in distant locations for the random chance of potential competition successfully bidding for a service heightens the level of uncertainty for the individual.

The traditional industries of steel, coal and shipbuilding are heavily dependent upon resources, which are geographically concentrated in particular locations. Job losses following capacity rationalisation would reflect this spatial pattern. This initial impetus in turn generates a variety of spatial impacts in local economies. For example, in the presence of local employment difficulties, spatial search increases (Simpson, 1992). As the next section will show privatisation events can lead to a spatial dynamic in labour markets.

The case for privatisation was reinforced by the belief that allocative inefficiencies in the provision of services could be improved by introducing competition. At the heart of the new thinking was the contestable markets model approach (Baumol, Panzar and Willig, 1982). This showed that, under certain conditions, the prospect of 'hit and run' entry by a potential competitor provided efficient welfare outcomes. This model was thought appropriate for the bus market. The White Paper on Bus deregulation suggested that the market is "highly contestable": entry costs are low; sunk costs are small in relation to overall operating costs; and, economies of scale are limited. There were important spatial considerations in this policy. Buses are an integral part of local transport networks providing travel for commuters, shoppers and casual users over short to medium distances. Before privatisation, bus routes in an area were usually supplied by a single (generally municipal) operator and regulated by local Traffic Commissioners who placed controls on price and entry. Emphasis was placed on integration, frequency and opportunity for remote users. However, public subsidies escalated whilst the growth in car ownership since the war had led to a steady decline in bus usage. Competition on profitable bus routes and bids for subsidies to run unprofitable services was to reverse this trend. However, the absence of an industry regulator when

combined with the advantages of size possessed by a few national firms created intense rivalry on individual bus routes. The contestable markets model broke down. Competitive outcomes varied across space depending upon local economic conditions and this raises questions about the regulatory process at the national and (sub)regional level.

The contestable markets model has also been applied quite intensively to those industries characterised as natural monopolies, the public utilities. A natural monopoly is said to exist where it is cheaper for one firm to supply a portfolio of goods and services than for two or more firms. Under strict conditions it is possible to show that a multi-product natural monopoly will price efficiently and not require entry controls (This is known as the Weak Invisible Hand Theorem, see Baumol *et al* 1982, Waterson, 1988). Further, changes in demand or costs (particularly through technological progress) may shift certain goods outside of the natural monopoly product portfolio (Sharkey, 1982). Over time, therefore, other firms may be able to supply goods or services once provided by a natural monopoly. This point has important spatial implications for the structure of privatisation for it could have encouraged the separation of the local part of the utility network from the national trunk system. The former is seen to have the technological attributes of a natural monopoly whilst the latter is subject to competitive forces and free to develop internationally. However, such policy was rejected.

Contestable markets rapidly became an important vehicle for 'New Right' policy makers in the 1970s and early 1980s. Academics responded somewhat belatedly, but critically, showing the immense difficulties in applying the contestable markets model to natural monopolies (or indeed to any industry structure; see, Vickers and Yarrow, 1988; Martin, 1993). Privatised public utilities embodied huge sunk costs particularly in networks. In addition, the existence of lag times between entry and full production provide an incumbent privatised monopolistic utility with advantages, which would deter potential competition thereby putting more pressure on the regulator to ensure prices reflect social welfare. With huge information asymmetries between regulator and regulatee this seemed unlikely. However, this did not deter privatisation protagonists. Where public utilities have substantial sunk costs due to the presence of networks the alternative is to divorce network ownership and use. Thus, it is possible to create direct competition on the supply of goods and services on networks where the product is simple, as in the case of gas, or where more complex products exist, auctions can take place to establish the right of use, as in the case of the railways (see Demsetz, 1968, on the principle of auctions). The network is heavily regulated to ensure that access to it is fair.

The unfurling of policy toward the privatised utilities has created a spatial dynamic. When the utilities were nationalised or quasi-nationalised they supplied on the principle of geographical universal service, and were largely distanced from local and regional development agendas (Marvin and Cornford, 1993). However, they had a regional structure, which was transferred upon privatisation. Thus, privatisation brought with it a regional focus in the supply of utility services, which has not disappeared even though the regulatory regime has changed. Problems of quality and inequality are ever present.

Privatisation creates labour relations problems within organisations it has affected and causes social distress following inevitable job losses. It also created a number of competition and regulatory issues at the local and regional level. These local labour market, competition and regulation issues are discussed in the next sections.

7.4. Employment issues

To provide some guidance about the employment impacts associated with the process of privatisation this section will summarise findings from the author's research in the North East of England and relate this to other local evidence. The previous section showed that two employment issues stand out. First, there are labour relations impacts associated with a privatisation event. Second, there is the issue of redundancy that inevitably occurs if, as the theory of privatisation suggests, the publicly owned organisation is over manned. To discuss the former CCT, particularly 'white collar' CCT in local government, is examined.

Redundancy problems are considered using the case of the North East Shipbuilders Limited, in Sunderland.

7.4.1. *Labour Relations: the case of CCT*

The regulations governing CCT in local government 'white collar' services (finance, housing management, information technology, personnel and legal services) were passed through parliament in late 1995, some four years after the government had introduced the idea in its White Paper, 'Competing for Quality'. During the interim intense lobbying had taken place and a number of concessions had been achieved. However, large proportions of services were to be put out to tender over the next few years. In local authority finance this eventually meant that over 50% of expenditure had to be subjected to competition, though there was a *de minimus* level of spending and some 'credits' were given for services that had already undergone some market testing. A project that the author was involved in considered the impact of CCT on the shape of the financial services function in local government by holding in-depth interviews with chief financial officers (CFOs) and senior officers in over half the local authorities of the North East of England during 1995 (See Hinde *et al*, 1996; Shaw *et al*, 1996). Financial services in local government is a multi-activity function, as Table 7.2 shows, and CCT made CFOs consider the distinction between core business functions, which had to remain in-house, and services which were key candidates for the tendering process.

Though all authorities interviewed stated that CCT was to be resisted by all means possible within the law, the research clearly showed that professionals wanted to shape the core business to suit their own interests. CFOs had held discussions about the functions most likely to be selected to meet the competition requirement within all finance departments; 'many a stormy departmental meeting' had been held, said one CFO, echoing the views of others. Even though they recognised the potential damage created by compulsory competition, CFOs talked openly about exposing services that were not integral to the corporate finance role, notably council tax and payroll. In defending such 'core functions' as accountancy and audit, finance officers mentioned the traditional importance of statutory responsibilities, the need to maintain a 'close relationship between treasurer and members' and the uncertainty over the supply of corporate financial management if key areas were lost. Indeed, one identified core accountants as the 'Praetorian Guard' whilst another detected a 'professional disinterest in revenues' at regional Association of District Council meetings. Payroll and Council Tax Collection were among the services deemed 'ancillary', reflecting lower levels of skill but higher levels of cost.

There was an intra-regional variation among the local authorities affected. Larger urban authorities found they could avoid the process by exploiting the credits system. Smaller, semi-rural, authorities, on the other hand, were much more likely to put services out to tender; those with least resources were being forced down the contractual route. Ironically, the rewards for the private sector would have been greatest if the larger authorities had been exposed to competition.

Table 7.2
Local Government Financial Services

Corporate	Financial planning and management Budget Preparations Controlling cash flow Statutory Section 151 responsibilities in the areas of internal audit and Accountancy	
Support	Creditors, debtors Payroll Management accounts Cashiers	
Direct Services	Council tax collection National non-domestic rates Benefits administration	(these three known as 'revenues')

Source: Hinde *et al*, 1996

A change to a Labour government in 1997 meant that the full impacts of CCT in finance were never really felt. Evidence from housing management CCT suggested that few private bidders won contracts in the North. Private concerns, however, did target far more southern authorities. A study by Shaw *et al* (1994) of 'blue collar' CCT (e.g. refuse collection, street and building cleaning) in North East local authorities echoes this finding. Such randomness would have heightened the uncertainty for employees within northern local authorities.

CCT created unnecessary tensions in labour relations for local authorities in the North East. It was seen as an expensive and divisive exercise internally. Where private sector bids were successful it led to greater fragmentation of service provision and greater difficulties for ensuring democratic accountability at the local level.

7.4.3. Redundancy

Privatisation has led to some dramatic reductions in employment. Blue collar CCT largely affected unskilled men. White Collar CCT, if it had been fully implemented, would have affected a larger proportion of women. CCT for cleaning, catering and laundry in the health service, which equally showed geographical variations, impacted most upon low paid women (Mohan, 1995). An examination of employment data for the Northern Region shows, that in the period prior to privatisation and for several years following, there were large job losses among men in the utilities sector and among traditional industries of steel, coal and shipbuilding. Whilst utility employment is geographically dispersed across the nation there are regional centres where employment impacts are concentrated. Steel, coal and shipbuilding, however, are dependent upon resources that are unevenly distributed across space, and in some communities they are the major source of employment. As the labour market experiences of the shipyard workers of North East Shipbuilders Limited (NESL), Sunderland, illustrate (see Hinde, 1994; Hinde, 1995) the effects of redundancy due to the privatisation process can have dramatic effects on the local economy.

As part of a deal between the British government and the European Commission to allow the subsidised sale of one of British Shipbuilders' yards to a private Norwegian firm, publicly owned merchant shipbuilding in the UK had to cease. This meant the closure of NESL, British Shipbuilders other merchant yard in December 1988. The direct job losses associated with the closure involved 2,092, mostly skilled men, with an average age of 37 years and 15 years service in the yards. The redundancy was phased over 3 years and a closure package announced. This included a support agency to help the redundant employees find new jobs and provide access to training. Infrastructure aid was also provided, partly by the government, who facilitated capital spending in the local economy via a number of agencies,

and by the European Commission, who permitted the establishment of an Enterprise Zone in the area and funded developments in subsequent years.

What was very apparent from this privatisation was the spatial dynamic that developed in the labour market. Over 40 % of the redundant workforce who used the support agency found employment in the local economy. Some were able to transfer their shipyard skills, but most had to retrain or go into low skill jobs. Very few took up the self-employment option. The other 60% found employment outside of the local economy. Most found work elsewhere in the North East, upgrading their skills by training. These redundant workers increased their travel to work distances as theory predicts. Those who worked outside of the North East (about 17%) did not migrate; they were 'travelling men' who lived in 'digs', hostels or on site, and returned home every week, fortnight or longer. They were usually married men under 50 with families, for whom away working caused family breakdown.

As well as these centrifugal forces, the infrastructure package created centripetal tendencies in labour markets. The industrial landscape of Sunderland in the late 1990s is very different from that of 10 years ago. This is partly due to the process of urban regeneration that began following the closure of NESL in 1988 as well as the closure of Wearmouth colliery in Sunderland in 1993. Both of these events plus the work of agencies has facilitated greater leveraging of European funding. The infrastructure and new firms associated with redevelopment on Wearside have provided jobs for commuters from the wider regional economy.

The changes brought about by the closure of NESL, did after a time bring a net income gain to Sunderland as redundancy payments, wages for those in work and infrastructure spending worked its way into the local economy (Hinde, 1995). This privatisation also facilitated an improvement in local labour market flexibility, a process that is much in evidence in the UK following the Conservative administration's reforms in the 1980s (Beatson, 1995). However, there are costs. Most of the redundant shipyard workers had multiple jobs often creating pressures for the existing pool of unemployed. For an unemployed person, success in the job market is often dependent upon the length of time unemployed as well as skill. As ex-NESL workers left jobs they pushed the existing unemployed further down the employment opportunity queue. Much of this happened in other locations as redundant shipyard workers looked to find employment outside of the local economy. However, there was a local impact too.

Discouraged workers are also an important feature of labour market changes. In the case of ex-NESL workers there were a large proportion of unskilled and older workers who went sick or took early retirement, encouraged partly by benefit rules. The 'real' unemployment rate (i.e. the registered unemployed, the sick, those who retired early and those in training) three years after the closure was nearly 42%. This compares to a figure of 32.8% of all Sunderland males who constitute 'real unemployed' in 1991 (Stone, 1995). A study of coal mining areas that had undergone similar closures due to privatisation pressures found the proportion of 'real' unemployed to be of similarly high levels (Beatty and Fothergill, 1995).

Labour market adjustment following privatisation is part of an on-going dynamic process but it accelerates the process in both positive and negative ways. It does lead to improvements in labour mobility, spatially and occupationally, though at the expense of rises in discouraged worker effects. The income impacts can be lessened if infrastructure investments are put in place and this will further encourage a spatial mobility of labour. However, not all privatisations have had the luxury of a capital spending programme or European funding. For example, during the privatisation process of UK railways some 2,300 jobs were lost in York in 1996 at the publicly owned British Rail and the private rolling stock firm, ABB. Whilst there was some local funding from the City Council, central funding was very limited and, because the area was not classified as Objective 2 status for EC purposes, no European regional funding was available. Although the impacts have not been fully researched, reports from the local economic development office described large increases in spatial search outside of the area by skilled men.

7.5. Competition, regulatory challenges and regional co-ordination

For those sectors which it has touched, privatisation has fundamentally altered industrial structure and brought with it intense strategic behaviour by those participants or potential competitors who seek profitable opportunity from the new market place. Table 7.3 which describes the nature of the utility and transport markets for the North East of England in 1999 shows that industry structures range from monopolistic (water) to 'tight' oligopolies with a dominant firm and a few smaller players (telecommunications). With the exception of buses, privatisation of the utilities and transport sectors brought with it specialist regulatory agencies charged with a duty to control potential excesses of market power. This has been a difficult task as a trawl through the regulators' annual reports and official government publications will testify. The two cases examined in this section, buses and the utilities, provide some insights and show the important challenges for policymakers charged with improving local economic development.

7.5.1. Competition, regulation and the local bus markets

Regulation of the UK bus industry following the Transport Act (1985) took two forms. At the local level the Traffic Commissioners registered and monitored routes operated by commercial firms. They have the right to withdraw licenses if safety is compromised but no competition powers (see Romilly, 1988, for more details). The Office of Fair Trading (OFT), who oversee general competition law in the UK and can make references to the Competition Commission (formerly the Monopoly and Mergers Commission (MMC)) for further investigation, controls competition abuses. Recommendations from the OFT and MMC then go to the Secretary of State for Trade and Industry who makes the final decision. However, as the Director General of the OFT recognised: "the regulatory system that we have at present is not sharp and flexible enough to deal with the problem that has developed in buses" (House of Commons, 1995, p.xxxiv).

The 1985 Transport Act abolished road service licences for all bus operators (except in London) and introduced a system whereby bus operators registered the services they intended to run profitably with the local Transport Commissioner. Local authorities then had to accept bids for subsidies to run less profitable routes in the area. The system was supposed to represent a contestable market with operators being able to move buses between routes if incumbent firms raised prices above competitive levels. The reality has been very different because there are substantial sunk costs required in establishing bus networks. The industry has become highly concentrated through merger and strategic behaviour. Currently in Great Britain there are four large bus operators, Stagecoach, First Bus, Cowie and West Midland Travel (owned by National Express), who account for over 50% of turnover. However, competition between any of them on particular routes is virtually non-existent. There is usually mutual forbearance among the large-scale operators concerning entry into each other's markets; it is considered a destructive strategy. Thus, most local bus markets (routes) are monopolies, where large national firms raise substantial barriers to entry (NERA, 1997). Large scale means that big firms can purchase new buses significantly (20%) more cheaply than small operators and, with younger fleets; they enjoy lower maintenance and operating costs per mile. Scale also provides entry barrier opportunities on the demand side. With more frequent services and a large regional presence customers can be tied into an operator by multi-journey or network tickets (analogous to frequent flyer schemes on the airlines). Furthermore, entry can be countered by rapid responses in price and output. When entry occurs it is usually small scale on niche routes (e.g. local estates) and sometimes requires a strategic alliance between parties based on a franchise agreement.

Where competitive rivalry between large operators on routes does exist it becomes so intense that the incentive for collusion grows. A recent case from the North West of England illustrates the problem (OFT, 1998). In 1995, after a period of intensive competition in each other's markets, two Manchester bus companies (First Manchester and Greater Manchester Buses South) and a Liverpool operator (MTL) formed a market-sharing cartel. MTL withdrew all its services from Manchester in return for the two Manchester based companies withdrawing from Liverpool. MTL then took many of its vehicles and deployed them in the

nearby St. Helens area, where they put pressure on a number of local operators to enter into a series of market-sharing agreements. Competition in the bus market in Liverpool was further reduced in 1996 when MTL entered into a series of price fixing agreements with local operators regarding short journeys, off-peak and children's fares.

Such anti-competitive behaviour is not unusual in the local bus markets across regions (including the North East), as recent MMC reports will testify. At present, however, the gestation period between offence and remedial action has been several years with adverse affects on victims (target firms and consumers). It was three years before the Restrictive Practices Court dealt with the North West cartel. Furthermore, rulings from the authorities on anti-competitive behaviour tend to be considered location-specific by bus operators. In its assessment of the undertakings imposed on ten miscreant bus companies by the MMC, NERA (1997, p.28) demonstrated that the operators affected had not introduced any company wide 'rules of conduct' to avert such behaviour elsewhere. In other words, operators recognised local bus markets as distinct from one another, and that local circumstances determine the possibility of anti-competitive behaviour in them.

Table 7.3: Utility and Transport Suppliers in North East England, 1999

Service	Providers	Spatial Scale	Degree of Competition
Telecommunications	BT MCL Cable Companies Cellular (mobile) Companies	Universal Limited Limited Universal	Developing competition for local, long distance and international calls in fixed line market. BT still the dominant player Growth in cellular market but still expensive.
Water & Sewerage	Northumbrian Water Hartlepool (Water Only Company)	Limited	Some competition in the South of the Region for large users. Otherwise monopoly provision.
Gas (Network controlled by British Gas)	Centrica (De-merged arm of British Gas). Northern Electric. A variety of other small gas and regional electric companies.	Universal supplier across the network. Others are limited suppliers but many companies part of an international energy group, e.g. Northern Electric	Competition exists at postcode level (where network permits) according to energy supply rules. British Gas still the dominant player. Strongest competition from Northern Electric.
Electricity	Northern Electric Centrica (De-merged Arm of British Gas). A variety of other regional electric companies	Limited in the UK. Possible universal supply from Centrica as market competition develops	Competition exists at postcode level according to energy supply rules. However, dominant player is Northern Electric. Recent opening up of the market to gas suppliers may have some impact at a later date.
Rail (network controlled by Railtrack)	Northern Spirit GNER Virgin EWS	Local services. Also operates TransPennine route with Scot Rail. Links to London and Scotland (east coast mainline). Main link to the northeast and the rest of the country (except London). Almost all freight services	Limited. Operators that won franchises have sole rights on particular routes. However, performance and quality problems noted by ORR. Out of 25 operating franchises, Virgin ranked 2 nd worse in 1998. GNER 6 th , Northern Spirit 10 th . Some competition on the 'edges' of the market where all three passenger operators run on the same line. There are also a few private freight operators within the market, but most run under license from EWS due to the prohibitive costs of obtaining a safety certificate
Bus	<u>Newcastle, Sunderland and South Shields:</u> Stagecoach. Some very small niche players <u>Teeside:</u> Stagecoach, Arriva Some very small niche players	Limited but players are part of a national group.	Players do not have much direct competition, except for a few routes in Sunderland. Classic monopoly on most routes in Teeside. Some entry deterrence issues but no known collusive activity as yet.

Source: Based on Marvin and Cornford (1993). Updated and Modified.

A change in the regulatory process is called for. One possibility would be to continue with the existing regulatory framework and change the legislation to favour victims. The new Competition Act (1998), which comes into force in 2000, allows for such a 'cease and desist' (or Prohibition) approach, whereby the offending firm has to stop activities immediately and prove that its action is not anti-competitive. Failure to comply will lead to fines. Alternatively, a sector specific regulator could be established, with particular powers to oversee competition issues in an industry that is highly concentrated at the national level but also highly localised. This latter view has won support from the House of Commons Transport Committee (1995) which also suggested that an industry regulator would consider travel issues more generally and liaise closely with local Transport Commissioners. It is also the preferred view of Bussell and Suthers (1999) who have studied the impact of bus privatisation on Teeside. They argue that bus privatisation has not been a panacea for customers. Whilst subsidies and costs have fallen, fares have increased and passenger journeys continued to fall. Although there have been no instances of anti-competitive behaviour identified by the OFT on Teeside, there are clearly instances of strategic behaviour, which could prove detrimental, particularly as other local markets have witnessed instances of predatory behaviour. Furthermore, they argue, transport policy requires greater integration at the local level to facilitate benefits for the environment, commuting and general passenger travel. In sum, bus privatisation requires a fundamental overhaul.

7.5.2. Utilities and regional co-ordination

Utility privatisation has not stimulated competition as some thought it would. Industry structures are evolving slowly partly because the initial privatisation was based on ideological or political factors rather than on economic reasoning. It was noted above that UK public utility privatisations embody natural monopoly characteristics in local networks and this may have allowed for more regional disintegration of services in the initial privatisation. This was particularly true of telecommunications. In the US, a decision was taken to divest the main operator, AT&T, of its regional operating companies, while at the same time licensing new competitors for the long distance route. The UK privatisation of BT in 1984 was controversial for it led to the creation of a mismatched duopoly. BT controlled their existing network. Mercury, the competitor, had a parallel, but limited network and required substantial access to BT's infrastructure. Hunt and Lynk (1991) summarising the evidence of the government's review of the duopoly some six years after the privatisation commented:

"The restructuring of local, long-distance and international services has ...been mooted. The available empirical evidence suggests that the separation of local services would not involve a decline in efficiency through the lost benefits of the joint production of these services. Technical change appears to have increased the feasibility of decentralised telecommunications services. Similarly, there are regulatory problems attached to the integrated nature of BT's operations. Arguments for the retention of an integrated structure therefore tend to rely on grounds of social equity and universal service. There are doubts concerning the validity of these arguments. Experience in the US suggests that the 'network externality' effects of bypass are not serious. Similarly, the argument that integration is necessary to provide uneconomic local services is challenged by the experience of Hull (a local UK provider) and other international examples." (pps. 85-86, my addition in parentheses)

This sort of argument could be applied across the utility sector. However, only water and sewerage companies have retained their natural monopoly attributes following privatisation.

Privatisation did provide an opportunity to return to a municipal form of utility ownership dating back to the last century. Municipalisation has lacked support, however, from all political post-war governments. The Labour government, 1945-51, that brought utilities under public ownership developed a significant degree of regional organisation within the national structure. The regional tier though had relatively little strategic decision-making power and was mainly concerned with distributing services, collecting payment and marketing products to consumers. National co-ordination was required for an integrated approach to economic development.

Privatisation of utilities has seen the development of a strong regional focus (Marvin and Cornford, 1993). The water and waste industry were sold off in 1989 as both local and regional companies, largely mirroring the geographical boundaries established some 15 years earlier. In the energy markets, British Gas, which was floated on the stock exchange in 1986, retained its vertically integrated structure and established regional cost centres, whilst the privatisation of electricity supply in 1989 divorced generation from transmission, distribution and supply and led to the formation of Regional Electric Companies who were Area Boards under public ownership. Railway privatisation in 1993 involved the divorce of network ownership and use. Twenty-five separate franchises were awarded to operators based on British Rail's former activities both by sector and geographical region. Separate operators may provide inter-urban and local trains but they serve a regional customer base.

Organisational restructuring, with concomitant unemployment, occurred as the regulatory regimes governing utilities have changed. Entry is now allowed but competition is limited. In telecommunications, regulators now license more operators to use the network and have allowed competition in other technologies to develop in local markets, particularly cable. However, by far the largest supplier is BT. Much the same argument applies to gas and electricity. The opening up of the gas market in the late 1990s entailed the vertical separation of distribution and supply monopoly held by British Gas through a de-merger and greater clarity on access prices for potential suppliers. Similarly, since 1998, any licensed supplier can access the electricity network and supply the local customer. In the domestic energy market gas and electricity firms can compete in each other's markets. However, there has been a limited uptake by customers. Less than 25 % have switched from British Gas, for example. Thus, in the North East the two dominant players, British Gas and Northern Electric, remain.

Clearly, targeting a regional customer base is important for utility companies but the regional input into utility regulation is very small. In the case of water, gas electricity and railway consumer interests are represented by between ten and twelve regionally based groups who are appointed by the industry regulator and act in an advisory role. One of their major functions is to provide information about quality and social equity within each region. However, they identify inter-regional variations in customer satisfaction. For example, in the water industry during 1997-8, complaints received by the regional Consumer Services Committees varied between 12.6 per 10,000 connections for Mid-Kent plc compared to a 3.2 for Sutton and East Surrey Water plc, a similarly sized Water Only Company. Among those supplying Water and Sewerage Services, Northumbrian Water Ltd fared best with 2.9 complaints per 10,000 connections, compared to Dwr Cymru Cyfnyedig (Welsh Water), a similarly sized organisation, which received 6.1 complaints per 10,000 connections. Complaints vary from region to region but most complaints are about charges or water quality (ONCC and CSC, 1998; see table 3 for similar information about trains).

Equity issues also show some spatial variations. A particular problem for Northumbrian water consumers has been the privatised system of charging which requires "greater fairness, transparency and affordability" for those on lower incomes within the area. Non-metered water is priced according to property values with those at the lower end of rateable values continuing to be charged considerably more in percentage terms than the average increase permitted by the regulator (ONCC and CSC, 1998). In the gas and electricity markets similar issues arise. Currently, customers who pay by direct debit through their bank account have price advantages over and above those who pay on budget or quarterly schemes, the latter usually being lower income consumers, who are distributed unevenly within and between regions.

In addition to improving the regulatory regime so that regional customers are provided with better performance and a fairer service, privatisation provides an opportunity for strengthening the strategic role of the utilities in regional economic development. Marvin and Cornford (1993) note a number of important reasons for this. Utility companies have an important bearing upon capital investment in the region and they offer employment opportunities in skilled activities. They can be important to new firm formation and regional exports. The performance and quality of indigenous firms can be boosted by their presence. They are an integral part of the image of the region, particularly in attracting inward investment to a region. The Northern Development Corporation, which had an important role in this respect, has cited the importance of cost and supply of utility services within the region as a crucial determinant in the location of overseas firms in the North of England. Utilities are thus an essential aspect of the competitive advantage of regions because

they facilitate the development of clusters of networked industries and services (Porter, 1990) and so strategic control at the regional level is vital. This is underpinned by the trend of global interconnectedness in utility supply since privatisation. Water, electric, gas and telecommunications companies that supply local communities are intertwined in a web of inter-regional and international relationships established with one another through mergers or strategic alliances. Some measure of strategic control over regional developments is thus more vital than ever.

7.6. Conclusion

These case studies show that the impact of privatisation on labour and product markets varies across space. Markets are often highly localised. In the case of CCT the market involved political boundaries and information barriers restricted private sector competition in more distant locations. Labour markets associated with traditional industries such as shipbuilding are also localised. Individuals have acquired highly specific human capital skills which, when redundancy strikes, are difficult to transfer except by retraining and increasing spatial search. Competition in bus travel is intense because markets are uniquely local (routes) and prevailing economic conditions heightens this uniqueness such that it may give rise to anti-competitive behaviour, particularly in the absence of strong regulation. In the case of privatised utilities, natural monopoly attributes of networks occur at the local level, whilst trunk routes facilitate more competitive supply at the regional, national and international level.

There are lessons to be learnt from these case studies. First, privatisation has impacted dramatically upon labour relations and increased human misery for those made redundant. An incremental approach that acknowledged spatial issues along with a sensitive economic development package would have softened the impacts. Second, a strong regulatory framework that incorporated sector-specific and local controls would have reduced anti-competitive behaviour in bus markets. Third, the acknowledgement of natural monopoly elements associated with utilities may have led to a spatially decentralised industry structure rather different to that which the UK has today.

Privatisation has had a long history in the UK and so it is important to look forward. This paper argues that the regional regulatory input and strategic focus of transport and utility provision is weak at present and there are important reasons why this should change. The labour administration's favourable attitude to regional government and its current review of transport and utility regulation may provide a catalyst for progress.

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Chapter 8

An Introduction to Competition Policy. Collusion and Dominance

8.1. Introduction

OECD governments punish anti-competitive conduct by firms, particularly collusion and predatory pricing, forcefully. The rationale for this is straightforward - activities such as this raise prices and restrict consumer choice in the immediate term or in the foreseeable future and so reduce economic welfare. However, not all would accept such a position but those schools of thought who have advocated a minimalist approach to competition policy are in a minority when it comes to examining what is applied in practice in OECD nations. Most have adopted a case law approach because of the complexities of individual markets. The situation is somewhat different in developing nations and economies in transition where the scope of intervention is more limited partly because of the lack of expertise in expediting competition matters but also because there is some uncertainty over what to control as a country develops. However, they will soon have to make a decision as to the route they wish to take in analysing competition.

By following this chapter and related activities you will

- ❑ Critically examine the debates about intervention in the sphere of competition policy.
- ❑ Review the developments in competition policy at the European Community level in respect of agreements between firms and the abuse of a dominant position through the use of case studies.
- ❑ Critically examine the process of recent changes in competition regulation in the UK.
- ❑ Undertake an activity to review the development of competition policy in a developing nation or in an economy in transition.
- ❑ Reflect on the nature and scope of regulation in competition matters.

8.2. Intervention in competition matters.

The origins of current competition policy in western nations lie with the work of Mason (1939) and Bain (1951). Essentially, this view espouses that given certain basic conditions on the demand and supply side of a market, the structure of an industry determines the behaviour of firms in that industry and this in turn will determine performance (see, for example, Martin, 2001; Lypczynski J and Wilson J, 2001). This is known as the Structure – Conduct – Performance (S-C-P) paradigm. Thus, a perfectly competitive industry – through the embodiment such as numerous buyers and sellers, free entry and exit into the industry for sellers, a homogenous product where no advertising prevails and perfect information about price for buyers and sellers – will lead to firms behaving as price takers. This results in an optimal industry performance where prices equate with their marginal costs (or, to express it another way, where market demand equates with unfettered market supply) and where firms earn profit levels that just keep them in that activity relative to their next best alternative.

Box 8.1: SCP and the Harberger Triangle

The traditional unidirectional view of the SCP framework can be illustrated by comparing monopoly with perfect competition (See the Figure below). For the moment consider the simple case of a perfectly competitive industry that becomes a monopolistic industry structure. We would expect that under perfect competition, where there is a particular market **structure**, characterised by free entry and exit, that firms will **conduct** themselves as price takers, and that would realise the optimal industry **performance**. Pareto optimality is achieved for the price people are willing to pay for an extra unit is equal to the cost of supplying that unit, i.e. price equals marginal cost. Or, demand (the price line or average revenue curve) equates with supply, for under perfect competition the supply curve represents the horizontal summation of the marginal cost curves. Equilibrium price and quantity is P_{pc} and Q_{pc} .

Under monopoly, by contrast, the structure is characterised by blocked entry and the incumbent firm's conduct is that of price maker or quantity setter. The firm maximises profits where marginal revenue equals marginal cost. Output is Q_m and at this output consumers are willing to pay a price of P_m . Performance is Pareto suboptimal as price is greater than marginal cost. Consumers are made worse off by the exchange process. They lose consumer surplus. Consumer surplus arises because consumers are willing to pay more for a good or service (as reflected by the demand curve) than they have to pay as reflected by the marginal cost (or supply) curve. Further, income is redistributed away from consumers and toward producers in the form of abnormal profit. Thus, some of the consumer surplus available when the market was perfectly competitive is transferred to producers because of their market power. Of course, producers are consumers too but this extra income arises not through the operation of input markets as in the case of other factors of production rather it is due solely to activity in the market for output. The Figure below illustrates the issues and the subsequent Table summarises the welfare changes. Note that the higher price and lower quantities experienced under monopoly rather than perfect competition give rise to an area of consumer surplus that is lost forever - sometimes called a 'deadweight loss'. It is represented by the triangle in area 3 of the Figure below, and called 'Harberger's Triangle' after the economist, A. Harberger, who made the first attempt to measure the size of welfare loss resulting from Monopoly in 1954, using USA data from the 1920s.

It is worth recalling the comment made earlier. Monopoly structures may not be a 'bad thing'. For example, if an individual has developed a 'wonder drug' then their innovative behaviour requires some protection. Without the establishment of property rights there would be no incentive to invent. Thus, patents protect and reward inventors whilst society benefits from the advancement of science. Likewise, monopoly may embody lower marginal (and thus average) costs via real economies of scale that, of course, reflect innovative behaviour. This could give rise to a gain in productive efficiency that may more than offset any welfare loss depicted in the static comparison between perfect competition and monopoly in the Figure.

Box 8.1 (continued)
Figure

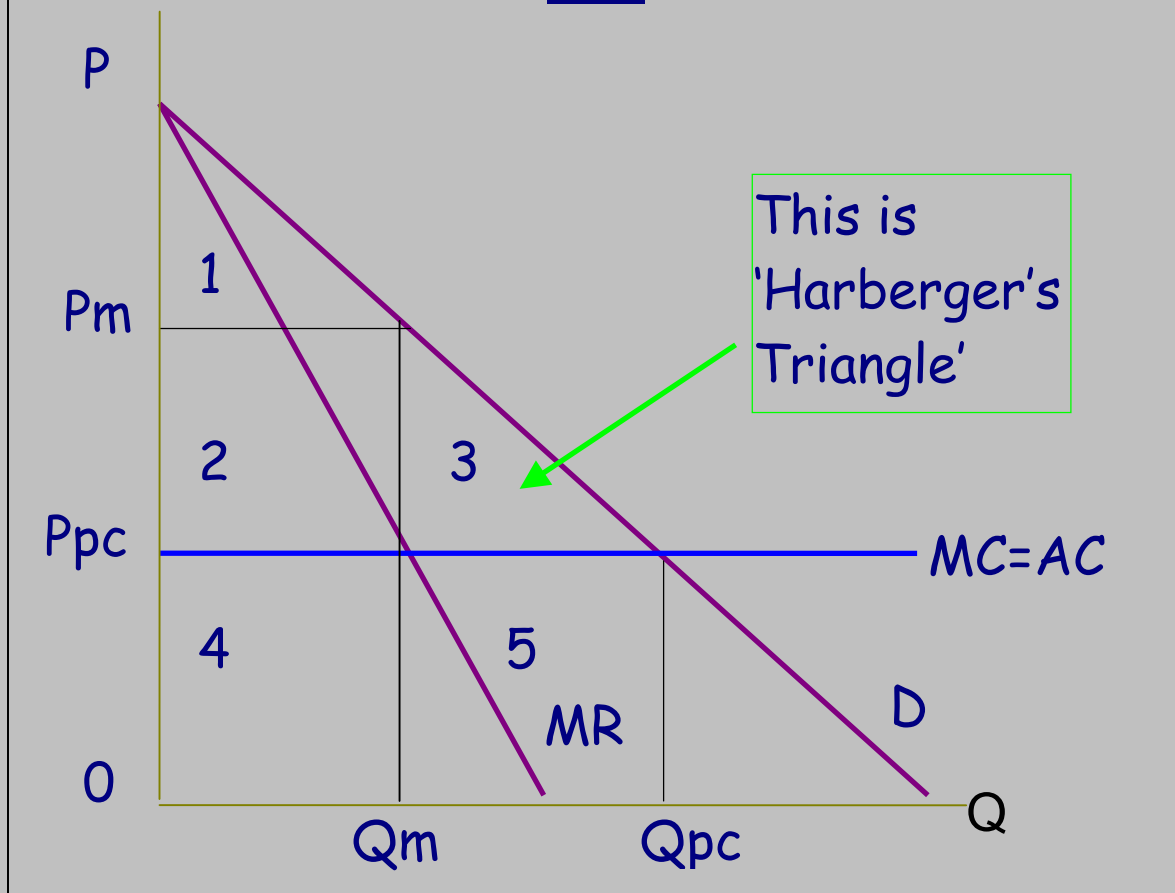


Table: Summary of welfare changes due to monopoly

Area	Perfect Competition	Monopoly
1	Consumer surplus	Consumer surplus
2	Consumer surplus	Abnormal profit
3	Consumer surplus	Deadweight loss
4	Input costs	Input costs
5	Input costs	Resources used elsewhere

Such a welfare optimising benchmark is often contrasted with a monopoly structure, i.e. where there is one firm in the industry with a unique product and there are many sellers, where potential entrants face great difficulty entering the industry and consumers have no substitute supplier from whom they can buy. In such a scenario a monopolist could raise their prices and /or restrict the quantity they supply onto the market. In other words, they can behave as price makers or quantity setters but they aim to maximise their profits at the expense of consumers. They keep prices above marginal costs by exploiting their market power and thus restrict industry performance by providing levels of economic welfare below that of perfect competition.

Clearly, there are some complications. Few markets are truly monopolistic. Most are oligopolistic with a few major players dominating the industry, competing for market share largely by using advertising or technology to differentiate their products. Similarly, as perfect competition was seen as an unrealistic 'Holy Grail' many who advocated the introduction of some controls on the worse excesses of market power considered more general benchmarks such as 'workable competition' – a long list of desirable characteristics that had some pragmatic application to an industry because they identified opportunities for successful performance. With complications such as this it did not take long for policy makers to notice that the causality did not just run from structure to performance in some deterministic manner. Indeed, the behaviour and performance of firms along with the structure of the market were interdependent. A whole host of views grew up recognising the complications and not all of them favourable to further intervention.

In addition to the 'structuralists' who posited the view that particular industrial structures led to certain performance there were also the 'behaviourists'. These believed that competition policy should be concerned with issues such as restrictive business practices (that is activities likely to restrict consumer choice, the most obvious of which is collusion) and mergers. In the case of the latter a simple example would be where two firms already in the same industry merged. The rationale for such a merger may be to enjoy economies of scale and thus improve efficiency. However, at the same time such an act would reduce the number of firms in the industry so that the possibility of higher post-merger prices would prevail. Competition authorities would need to balance out whether the productive efficiency gains outweighed any allocative efficiency losses from the higher prices and lower quantities on offer.

More importantly, from a policy perspective, the existence of numerous potential outcomes from different behavioural practices suggested a 'case-by-case' approach to competition policy. A point echoed by the 'New Industrial Economics' school who use game theory to explain interdependencies between competitors in oligopolistic markets. Thus, competition policy has become a regulators paradise with each potential case requiring a detailed analysis as to whether a firm has a dominant position in a particular product and geographical market. Once this possibility exists further detailed examination of the abuse is required.

However, there is considerable opposition to an overly interventionist approach to competition policy. Working within the same neo-classical tradition as the structuralists and behaviourists, economists notably from the Universities of California at Los Angeles and Chicago proposed a very different interpretation of the S-C-P paradigm. Indeed, this view proposes that large oligopolistic firms have achieved success via efficiency. Thus, rather than market structure being a determinant of performance, performance determines the number of firms (and their size) within a particular market structure. In such a scenario regulation of monopolies and mergers is not required. The existence of large firms signals successful performance in the market place and regulators should not interfere in the business of innovative managerial behaviour. Where intervention is required it is in enabling free entry and exit and desisting from the imposition of trade barriers and other market controls.

In a similar vein the theory of Contestable Markets considered how given free entry and exit into a market and the possibility of zero sunk costs actual competition would guarantee market efficiency with prices equating with average costs (Baumol *et al*, 1982). Whilst this approach suffered from a 'non-robustness' problem in the presence of even a miniscule level of sunk costs (see Vickers and Yarrow, 1988) and was later discredited as a general theory of industry structure, it provided some valuable insights as to the changing nature of natural monopolies and so challenged the very rationale for state ownership of public utility networks such as telecommunications. It also helped to establish (indirectly perhaps) what has been known as Chadwick-Demsetz auctions,

after the 19th century public health reformer and Chicago economist, Harold Demsetz, who both advocated the separation of the sunk cost element associated with public utility networks and an auction for the right to use the network. In the UK this is probably best demonstrated by the privatised Railway system in which one company owns the network and train operating companies bid for the right to run on particular timetabled routes.

The 'Chicago School' is also very sceptical about the likely effects of firm behaviour. For example, it believes that control of cartels should be minimal as they are susceptible to cheating. In addition, issues such as predatory pricing can be eradicated by improving information flows to capital markets and consumers. In such circumstances, customers will not become brand disloyal and switch to the lower price rival now recognising that once competitors have exited the market the dominant firm will raise prices once again.

Although coming from a different tradition and critical of the static nature implied by neo-classical economic theory, the Austrian school of thought equally emphasizes the importance of minimum intervention. Competition is seen as a process and is at its most efficient when entrepreneurs compete against each other. The threat of competition also ensures energies are channelled into providing new products that may be discovered by other entrepreneurs, more alert to consumer needs; in this way encouraging entrepreneurial discovery. A monopoly position, from this point of view, arises out of a firm being fully aware of consumer needs such that there are no opportunities for competition. If this is the case then monopoly should be welcomed, not prevented. Government intervention in this view is often clumsy and can dampen firms' alertness to consumer needs.

However, the history of competition policy in advanced industrial nations is one of creeping intervention. This is seen as a necessary pre-requisite for a more equitable society. The 'do nothing' or 'do little' approaches have been rejected. Policy makers have adopted frameworks of competition law through Acts or treaties that signal to producers and consumers alike that there are boundaries over which the former cannot cross. Yet the complexity of each individual situation has led to a case-by-case approach in which competition authorities build up case law to guide them in the decision making process. The emphasis is on the conduct of a firm with a dominant position. The size of the firm is of secondary importance if there are or likely to be sufficient substitutes for its products. However, if the firm is found to have a dominant position in the carefully defined market place and is behaving in a way to restrict consumer choices or raise prices, either now or in the near future through its current actions, then it is likely to come under close scrutiny from competition authorities.

8.3. Developments in Competition Legislation: The European Community and the UK.

What exactly have authorities done in the field of competition policy? In this section we analyse developments in the UK and the European Community in respect of agreements between firms and the abuse of a dominant position. The former usually associated with collusive behaviour between firms, the most explicit form of which is a cartel. One theoretical explanation of the existence of collusion is that of the long run Prisoner's Dilemma game in which conditions in the market lead to firms sharing markets or agreeing on prices. In some cases collusion can be explicit, that is the parties involved have declared their intentions (possibly through a written agreement!). In other cases, the collusive behaviour is implicit perhaps firms are following the price movements of one of the largest firms in the market so that their prices move together but 'due to factors beyond their control'. Such situations are more difficult for competition authorities to prove. Evidence suggests that most collusion occurs in those industries where there are a few sellers (so they can police each others activities); where the products are identical, at least in the eyes of the consumer; where each firm's costs are similar, so that neither has a distinct advantage; where technology is fairly well established (that is, in mature product industries); and in situations where future demand is fairly predictable (See Martin, 2001; Lypczynski and Wilson, 2001).

Interestingly, competition authorities find more evidence of collusive behaviour between firms than they do abuse by one dominant firm (though there have been occasions of collective abuse).

There are a number of examples of abuse of a dominant position that can be cited but the one used in this chapter relates to predatory pricing. Predatory pricing is extensively discussed in industrial economics textbooks so the analysis here will be brief. Predation is a short-run strategy by an organisation that seeks to exclude rivals on a basis other than efficiency in order to protect or acquire market power. Thus, the predator may reduce prices to such a low level that it induces exit by a target firm or deters potential entrants, or they may engage in non-price conduct which raises rivals' costs. Usually such a strategy requires the predator to sustain short-term losses along with its victim(s). It therefore makes little sense unless there are significant barriers to entry into the affected market. Otherwise, the predator will be unable to raise prices and recoup its losses once the victim(s) exit the market. There may also be cases where predation amounts to an investment in reputation, enabling the predator in other markets or at other times to secure a larger, more profitable market share by merely threatening to predate.

In the following sections we examine the treatment of agreements and predatory pricing using the policy frameworks adopted in the EC and the UK. You should note that OECD countries have competition policies that are similar in scope if not in design. Very significantly though non-OECD countries are actively seeking advice on the development of competition policies from their OECD allies.

8.3.1. European Community Competition Policy

The origins of European competition policy can be traced back to 1953 when the European Coal and Steel Community was created. These strategic commodities were considered essential to an integrated post second world war Europe and so attempts by businesses or government to restrict their supply were considered as detrimental to economic welfare. With the Treaty of Rome in 1956 came the formation of the European Economic Community and the creation of the European Commission Directorate, DGIV. The key to the development of European competition policy since that time has been the development of an integrated single market in which there is unfettered trade in goods, services, people and finance. However, it is only since the mid-1980s when the EC policy machine moved forcefully to bring in the Single European Act by 1993 that the creation of a Common Market was truly realised.

The powers of DGIV, enshrined in the Treaty of Rome, allowed them to deal with four broad areas relating to competition policy – agreements between undertakings that may be incompatible with the common market, abuse by one or more undertakings of a dominant position, merger controls; and the provision of State Aid by European governments. Unfortunately, there is limited space and time to deal with the important issue of State Aid. Interested parties are referred to Martin (2001), though the discussion in the previous chapter on the closure of Sunderland Shipyard was related to the issue of State Aid to a 'sunset' industry. Discussion of European Merger control is dealt with in the following chapter. In this section we concentrate on agreements and abuse of a dominant position, which were covered by Articles 85 and 86 of the Treaty of Rome 1956 but since the Treaty of Amsterdam in 1999 have been subsequently renumbered as Articles 81 and 82 respectively. Details of Articles 81 and 82 are set out in Table 8.1.

Article 81

Agreements that have an impact on trade between members of the European Community and thus on the welfare of the Common Market should be reported to Directorate General IV, the EC Competition Commission. Not all, however, are, partly through ignorance but also because the participants recognise that they are engaging in an agreement that falls within Article 81 section 1. Those who do report their agreements are looking to demonstrate that they fall within section 3 of the article and thus are eligible for an exemption. In some cases the exemptions are awarded for individual agreements though given the potential workload the Commission has adopted a policy of awarding block exemptions for particular industries. Probably the most famous of which is the block exemption in the motor vehicle industry which is coming up for renewal in late 2002 (see http://europa.eu.int/comm/competition/index_en.html). The best way to demonstrate the operation of Article 81 is via 2 case studies.

Table 8.1

Articles 81 and 82 of the Treaty of Amsterdam (ex. Treaty of Rome)**Article 81 of the EC Treaty (ex Article 85)**

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:
 - (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
 - (b) limit or control production, markets, technical development, or investment;
 - (c) share markets or sources of supply;
 - (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
 - (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.
2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.
3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:
 - any agreement or category of agreements between undertakings;
 - any decision or category of decisions by associations of undertakings;
 - any concerted practice or category of concerted practices,
 which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
 - (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
 - (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

Article 82 of the EC Treaty (ex Article 86)

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Source: European Commission,

http://europa.eu.int/comm/competition/legislation/treaties/ec/new_numbering.html

The 2 brief case studies presented in Table 8.2 examine a horizontal overt cartel, that of the District Heating Pipe Cartel, and a vertical cooperative agreement, that of OPEN (British Interactive Broadcasting). By Horizontal Agreement we mean agreements between firms in the same sector, whilst Vertical Agreements refer to agreements between firms across sectors, perhaps manufacturing and retailing. In the case of OPEN the sectors are television and the 'set top' communication box, telecommunication links and transaction merchandising, which means secure online credit card transactions by a financial institution.

The principal difference between horizontal and vertical agreements from a competition policy perspective is this. Horizontal agreements are usually illegal (there are notable exceptions, namely the formation of strategic alliances to overcome huge sunk costs as in the case of the building of aircraft) and firms try to avoid detection. Just look at the case of the District Heating Pipe cartel below. Vertical agreements, in contrast, usually involve firms seeking guidance and advice from competition authorities on agreements that, whilst potentially monopolistic, offer society much wider benefits. Look at the OPEN case below. Being able to buy a pizza, order a stereo or some other product using your television set was quite revolutionary in 1999 (of course we are likely to have an Internet TV revolution shortly). Most people buy goods electronically using the Internet but the European Commission considered OPEN to be a very different market. OPEN allow you to buy goods from your armchair using what is essentially an entertainment medium available in virtually every sitting room. So OPEN offers greater choice for consumers in the digital age. The problems were

- a) two companies could supply the product separately – BskyB and BT are major suppliers in the distribution of digital TV.
- b) BskyB offered movies and sport to cable and terrestrial digital TV and might use their power in one market to influence another.
- c) Only one company was commissioned to supply set top boxes.

Thus, the companies obtained an exemption from Article 81 of the Treaty of Amsterdam by making their case to the European Commission.

Table 8.2

THE REGULATION OF AGREEMENTS IN EUROPE: TWO CASE STUDIES

Case 1: The District Heating Pipe Cartel

In this instance a cartel of at least ten companies in the market for district heating pipes developed. ABB, a Swedish company, was seen to be the dominant force in this cartel. ABB had expanded through acquisitions. By 1992 it possessed 40% of the European market. The cartel initially began in the Danish Market in the early 1990s between four domestic producers. Prices were much higher in Denmark than in other countries. The collusion was extended to Germany when two German producers were brought into the cartel. ABB, however, wanted a 'European solution', a cartel to exist as an overall Europe-wide cartel. Initially this was not to be as in 1993 some refused to 'sign-up' for the 'arrangements' and a price war commenced.

In 1994, however, a Europe-wide cartel was initiated, covering the Baltic States, Eastern Europe and the EU. The companies involved essentially operated a secret price fixing, market sharing and bid-rigging cartel. Each was allocated a sales quota and committees were set up to run the cartel. Common price lists were devised and the aim of the cartel was to raise prices by 30% in two years. Bid rigging became the normal practice. One firm would be nominated to win the bid and others would be informed of their bid. The others had to submit a higher quote than that of the 'favoured firm'.

Powerpipe, a privately owned Swedish concern was the so-called 'spanner in the works', as they would not agree to join the cartel. Powerpipe subsequently won a large project/contract based on its competitive price. The members of the cartel met and vowed not to supply Powerpipe with any materials or provide subcontractors. The cartel threatened Powerpipe with reprisals unless it

agreed to confine its business to the Swedish home market. If Powerpipe agreed with the other cartel members, it would receive a guaranteed quota. If it did not it could face bankruptcy.

The Commission found out about the cartel, through Powerpipe. When the Commission carried out investigations, unannounced, at the cartel members' headquarters they found 'Smoking gun' evidence of collusive activity.

Fines were imposed on the ten members of the cartel totalling over 90 million Euros. ABB received a fine of 70 million Euros. Some of the cartel members co-operated with DG 4, the European Competition Commission, providing them with more evidence and were offered a discount on their fines of between 10% and 50%. Although the fines were very hefty in this case, they do not seem to deter others from illegal price fixing.

Case 2: The British Interactive Broadcasting Decision

This case concerns the creation of a vertical agreement between 4 companies in the digital interactive television market. The companies involved were engaged in the UK market but because of the (at the time) revolutionary nature of the product and its potential for the European market they sought guidance from the European Commission (Directorate IV, Competition) as to whether it was eligible for exemption under Section 3 of Article 81 of the Treaty of Amsterdam. The parent companies of OPEN (originally called BiB, British Interactive Broadcasting) are BskyB Ltd, BT Holdings Limited, Midland Bank plc (now HFC Bank) and Matsushita Electric Europe Ltd. BskyB would supply the television service and the digital technology; Matsushita would supply the 'set top box'; BT would provide the communication technology and Midland Bank would provide the secure transactional service by which consumers could order products via their TV sets.

The Commission did express some concerns about the arrangement, notably that the operation 'eliminated BT and BskyB as competitors in the digital interactive television services market' (BT had a strong presence in the cable TV market). Both would be able to 'go it alone' in the digital interactive television services sector.

However, the Commission believes that it is in the public interest to allow the companies to co-operate. The benefits to consumers accrued from the technical advancements developed by the companies from working together. In addition, there a new form of service has been created, which would have taken longer to materialise if it had not been for the co-ordination of the two technological companies. The new service allows retailers of goods and services to sell their products using a new outlet, the armchair-TV consumer. It can be argued that the 'joint venture, therefore, contributes to an improvement in the distribution of goods and technical and economic progress'. Consumers benefit owing to the introduction of the new service via their televisions, as the Internet and e-mail and buying on line facilities become available to the mass market through television sets as opposed to computers.

In making their decision the Commission had to take note of the relevant market. It stated that there is a distinction between the package of interactive services offered by Open and high street retailing and interactive services via personal computers. Thus there is likely to be a price difference between the goods and services from the digital interactive service and the high street. Therefore the Commission noted that there are strongly defined markets. The services provided by computer and by television could also be seen as separate product markets owing to the fact that a television and a computer are situated in different environments, and that the initial outlay for a PC with a modem is relatively high. There are also different markets here as retailers have stated that they would target different customers using different brands, depending upon their use of a digital interactive service via a TV set or a PC.

There is also a distinction between the pay television service and the digital interactive television service. One is primarily for the imparting of entertainment and the other a transaction-based or information service.

The Commission allowed the agreement to proceed because of the positive benefits but imposed conditions on the venture because of their competition concerns about the possible development of a collusive position. These included

- _ that the parent companies must not hold more than a 20% stake in a competing company;
- _ BT divesting its cable interests to ensure competition from the cable networks
- _ allowing third party access to BiB subsidised set-top boxes;
- _ requiring third party access to BskyB's pay-TV channels.

Sources: Adapted from

Font Galarza A (1999) The British Interactive Broadcasting Decision and the application of competition rules to the new digital services. *Competition Policy Newsletter*, no. 3. October, pp. 7-15.

Joshua J (1999), Cartel Enforcement, *Competition Policy Newsletter*, no. 1. February, pp. 27-39

Article 82

Article 82 of the Treaty of Amsterdam regulates against the abuse of a dominant position by a dominant firm in an industry (although there is also provision for 'collective dominance', i.e. where two or more firms in an industry abuse their dominant position). A dominant position is dependent upon the definition of the market and so any enquiry into dominance must examine the prevailing supply and demand conditions. Very loosely a dominant position exists where there are few substitutes available for the product or service on offer and where entry into the market by potential competitors is difficult. For DGIV this has usually meant that no in-depth investigation will take place unless a dominant firm has at least 40% of the market and this has usually extended to a 60% market share. However, as we noted above, the existence of a dominant position is not a necessary condition for abuse. Table 8.1 shows abuse of a dominant position may take place if a firm engages in an 'unfair' prices or limiting production or putting trading partners at a 'competitive disadvantage' by not offering the same conditions for equivalent transactions, or for restrictive clauses in contracts. Such a policy position may be difficult to establish. Firms with large market shares may just be more efficient. Excessive prices may reflect innovative behaviour or demand increases in industries where capacity is fixed in the short run. As a result supernormal profits are realised. To establish whether an abuse has occurred it is necessary to have persistently high prices that does not induce entry or reduce market share.

It is the case that there are far fewer cases covered by Article 82 than Article 81 or picked up by European merger regulation (see the next chapter). Yet there are some famous instances where there has been an abuse of a dominant position. The case of Tetra Pak noted in Table 8.3 below is a good example of 'predatory pricing'

Table 8.3

**ABUSE OF DOMINANCE AND MONOPOLISATION:
THE CASE OF TETRA PAK**

On 24 July 1991 the European Commission handed down a decision citing the Tetra Pak group for infringements of Article 82 (ex. Article 86) of the EEC Treaty.

Tetra Pak, an originally Swedish group established in Switzerland, is far and away the world leader in the field of packaging liquid foods (primarily milk and fruit juices) in cartons. It had turnover of ECU 3.6 billion in 1990. In 1991, Tetra Pak acquired the Alfa Laval group, one of the world's foremost manufacturers of milk processing equipment, with turnover of some ECU 2.5 billion.

In its decision, the Commission held that the sector for the packaging of liquid foods in cartons

comprised four distinct markets: on the one hand, those for the filling machines and the cartons used for aseptic packaging of "long shelf life" liquids; and on the other hand, the markets for the filling machines and cartons used for non-aseptic packaging of fresh liquids². The Tetra Pak group possessed some 90-95 per cent of the two aseptic packaging markets and between 45 and 50 per cent of the non-aseptic markets. The Commission deemed that Tetra Pak held a dominant position in the first two markets, but it did not think it necessary to rule on the existence of such a position in the non-aseptic packaging markets, considering that, in any event, those markets were "neighbouring and associated".

The investigation, initiated after a complaint by one of Tetra Pak's competitors, had led the Commission to consider that on the aseptic and non-aseptic packaging markets alike Tetra Pak was committing numerous and varied abuses within the meaning of Article 82 (ex. Article 86) and that those abuses formed part of an overall group strategy.

Taking advantage of its dominant, virtually monopolistic position in the aseptic packaging markets which, when combined with a leading position in the non-aseptic packaging markets, made it the only possible supplier for most of its customers. Tetra Pak had forced those customers to accept contractual obligations aimed primarily at tying them to the group and precluding any trade in its products. By using these contractual obligations to minimise the possibilities for interbrand competition, and by precluding any intra-brand competition through those same requirements and its entirely autonomous production and distribution policy, the group had compartmentalised national markets for its products within the European Community so that it could carry out a differentiated and discriminatory pricing policy for its cartons and machines alike. All of the conditions for restraint of competition were satisfied, so that in the area where it had established a virtual monopoly (the "aseptic" markets), the firm was able to pursue a profit maximising policy to the detriment of consumers a policy that in turn enabled Tetra Pak to subsidise predatory pricing in areas where there was still some competition (basically, "non-aseptic" markets). To maintain or strengthen that position, Tetra Pak had taken pains to bolster its contractual and autonomous development policies with a wide ranging defence of intellectual property rights, using all sorts of specific measures, including, when necessary, the acquisition of competitors or, failing that, their technological innovations.

Because they had an impact on practically all aspects of marketing policy, took the most widely varied forms, involved all (or virtually all) of Tetra Pak's products and affected all of the Community's Member States, these infringements were part of an overall strategy to oust the competition. They had highly detrimental effects on competitors and users alike, enabling Tetra Pak to preserve its virtual monopoly in the aseptic packaging markets and to considerably enhance its position in the non-aseptic markets (probably to the point of establishing dominance there as well).

In particular, contractual stipulations that only Tetra Pak cartons be used on Tetra Pak machines were a major factor in blocking any effective competition in the aseptic packaging markets. In addition, they ensured that Tetra Pak would derive steady income from carton sales over a machine's entire lifetime (or rental period). Moreover, the prospect of such guaranteed carton income could not help but encourage discriminatory and predatory pricing practices with regard to the sale and rental of filling machines practices that were effectively carried out.

Meanwhile, the segmentation of the European market also made it possible for Tetra Pak to engage in radical price discrimination between Member States, with variations of as much as 50-100 per cent for cartons and 300-400 per cent for machines.

Profits generated by the Brick cartons used for aseptic packaging, for which Tetra Pak enjoyed a virtual monopoly, were such that the firm could easily absorb the losses it at times sustained on some (or even all) of its other products, a luxury its competitors could not afford. For example, the fact that for years Tetra Pak sold its Rex non-aseptic cartons in Italy at a loss of up to 34 per cent (and in some cases more) of their cost forced Elopak, its chief rival, to shut down a new production facility in the country and almost completely eliminated it from the market.

At the conclusion of the procedure against Tetra Pak, the Commission therefore directed the group to cease its infringements, decided to impose a fine of ECU 75 million (the highest fine ever

imposed on a company for infringing competition rules) and laid down certain obligations for the firm's future conduct. In its judgement of 6 October 1994, the Court of First Instance (CFI) of the Court of Justice of the European Communities confirmed all aspects of the Commission's analysis and its decision, including the obligations imposed on Tetra Pak for its future conduct, and confirmed the fine levied by the Commission. Following the CFI's judgement, Tetra Pak paid the fine (over ECU 100 million, including interest) but decided to appeal to the Court of Justice.

SOURCE: OECD (1996) Abuse of Dominance and Monopolisation, OCDE/GD(96)131, pp. 173 – 174. Available at <http://www.oecd.org>.

8.3.2. Recent Developments in UK Competition Policy

Since May 1997 the Labour party, a left of centre political group, has governed the UK. Labour's landslide victory in the General Election of that year was due in no small measure to its campaign to woo the voters of 'Middle Britain' and, in particular, the business community. Years of opposition led to a realignment of Labour Party policy toward industry. 'Old Labour' policy of nationalisation, industry planning and fiscal profligacy was ousted. The 'New Labour' party manifesto of the pre-1997 election emphasised fairness for all business stakeholders and collaboration in its dealings with the corporate world. In doing so, it has argued the need for an appropriate regulatory framework to facilitate competition. One of the main aims of competition reform has been to impose a minimum burden upon business and achieve effectiveness of outcome for society. To attain this the 'New Labour' government has stressed the significance of consumer sovereignty as the principal 'public interest' criteria guiding competition policy rather than allowing wider issues, such as protecting jobs or maintaining regional identity, to prevail.

Traditionally, these characteristics of policy had been the domain of Conservative governments. Over the period 1979 to 1997 Conservative administrations had introduced privatisation, transferring ownership of a large proportion of once public sector assets and services to the private sector. They accompanied this by the de-regulation of numerous markets, allowing private firms to participate in ways that, hitherto, they had been unable to. Unfettered capitalism was thus the goal of free market ideologues in conservative governments and elsewhere.

However, the policies which brought ballot box success in the 1980s and early 1990s had been sown with the seeds of an alternative realisation: that such an ideological change shifted the weight of opportunity away from consumers and taxpayers, who had been the main beneficiaries of the privatisation sales and deregulation policy, and toward the newly formed privatised monopoly suppliers and ('fat cat') directors.

In addition, the Conservative government of 1992-1997 could not develop upon the earlier electoral success associated with privatisation and deregulation by altering the regulatory balance back towards the consumer. This was a time of "muddling through" on policy towards re-regulating industry (as well as other aspects of policy). And this was particularly apparent in the field of traditional U.K. competition legislation, notably in respect of regulating cartels and the abuse of market power. Conservative Governments immersed themselves in three important investigations – a 1989 White Paper, entitled 'Opening Markets: New Policy on Restrictive Trade Practices'; a 1992 Green Paper, entitled Abuse of Market Power - A consultative Document on Possible Legislative Options' and a discussion document in 1996 entitled 'Tackling Cartels and the Abuse of Market Power. An Explanatory Document.' However, nothing emerged in statute, despite of protestations from consumer groups, some firms and opposition politicians. UK legislation on Competition was a legacy of the 1970s. Legislation on restrictive practices comprised of a register backed by a Restrictive Practices Court. Each case before the court was judged on individual merits. It was time consuming and ineffective in punishing the worst abusers of collusive behaviour. Control over the abuse of a dominant position involved ex post (after the event) lengthy investigations at the end of which a report was published as a shaming mechanism. Indeed, whilst an investigation into alleged collusion or abuse of a dominant position was being carried out the activity could continue. In contrast many other European countries had adopted the European Commission prohibition model in which fines and 'stop now' notices

prevented alleged anticompetitive activities from occurring and, where guilt was found, substantial fines. UK conservative politicians resisted the move toward a European style regime because they believed that it would require an increase in compliance costs for firms in embracing a new approach. In addition there was a general fear among conservatives politicians of aligning with European regulation for fear of an erosion of national sovereignty. However, in 1997 with general failures in policy a Labour government came to power and, in the field of competition policy, quickly launched a new Competition Act.

The UK Competition Act 1998

The Labour government introduced its Competition Bill into the House of Lords in early 1998. This received Royal Assent in winter 1998 and became law in March 2000.

The new Competition Act introduced two prohibitions (known as the 'Chapter I' and Chapter II' prohibitions) that are intended to strengthen competition law by deterring anti-competitive behaviour. Both prohibitions align U.K. law with European Commission competition legislation as they are based upon Articles 81 and 82 of the Treaty of Amsterdam (ex articles 85 and 86 of the Treaty of Rome). European legislation provides prohibitions in respect of cross border issues whilst the new U.K. competition framework uses a wider net to avert anti-competitive structures and conduct. The latter is captured by the new prohibitions, the former by the Fair Trading Act 1973. The new competition framework places emphasis on whether conduct by firms has any appreciable effect on competition rather than the wider public interest concerns. This echoes EC legislation but the Government has refrained from a precise definition of 'appreciability', preferring to rely on a case-by-case approach. Table 8.4 summarises the main differences between the old and new competition regimes.

The main prohibition is enshrined within Chapter I of the Act and deals with anti-competitive agreements such as cartels between companies and associations of companies. These are situations where organisations

- fix, either directly or indirectly, purchase or selling prices or any other trading conditions.
- limit or control production markets, technical development or investment
- share markets or sources of supply
- act unfairly in equivalent transactions with other trading parties
- conclude contracts with parties which subject them to supplementary obligations which have no connection with the subject of the contract.

There are some exclusions and exemptions from the Chapter I prohibition, for example, where there is parallel agreement under an EC ruling. Individual agreements can be granted exemption by the Director General of Fair Trading (DGFT). However, agreements can only be granted exemption if they contribute to "improving production or distribution or promote technical or economic progress while allowing consumers a fair share of the resulting benefits". Further, they must not impose "restrictions which are not indispensable from the attainment of those objectives" or eliminate "competition in respect of a substantial part of the products under question" (Draft Competition Bill, 1997, clause 7). The first case of an abuse of the Chapter I Prohibition was between two bus companies (see Table 8.5) which given the problems suggested in the previous chapter on privatisation of the bus industry is perhaps unsurprising.

The Chapter II prohibition captures anti-competitive behaviour by dominant firms. The emphasis is on tackling abuse of a dominant position rather than the holding of the dominant position itself. The prohibition embraces anti-competitive conduct such as price discrimination, predatory pricing, full-line forcing, rental-only contracts, exclusive supply and selective distribution. It will not lead to the repeal of the Fair Trading Act, 1973, which will be left to deal with abuses resulting from market structure and the operation of the market. For complex monopolies, defined by the Fair Trading Act as where two or more firms who have 25% or more of the U.K. market and conduct their business so as to distort competition, both of the prohibitions capture "parallel behaviour resulting from the agreement between the parties" (DTI, 1997, p.21). However, where such agreement is absent then the Fair Trading Act has a role to play.

The Act represents a fundamental transformation of U.K. competition law. Chapter I prohibition replaces The Restrictive Practices Act, 1976, and the Resale Prices Act, 1976. There will also be a winding down of the Restrictive Practices Court. The Chapter II prohibition, whilst leaving the Fair Trading Act largely in tact, repeals most of the 1980 Competition Act.

The new prohibitions give new powers to the DGFT. These include the power

- ❑ to enter premises, by force if necessary, and copy documents.
- ❑ to impose interim measures pending the completion of an investigation.
- ❑ to impose financial penalties on big business, up to 10% of their total U.K. turnover - there are exclusions from financial penalty for Small and Medium Sized Enterprises and leniency for 'whistleblowers'.
- ❑ to direct parties to bring infringement of prohibitions to an end.

Under the new law, the DGFT can, if necessary, enter and search premises for information in lieu of a monopoly reference. Further reform of the Fair Trading Act will allow the DGFT to make recommendations either to the Competition Commission (an revamped Monopolies and Mergers Commission) to investigate further or to the Secretary of State that the organisation(s) concerned will accept undertakings (though the latter has now been taken out of the process to facilitate political independence). The process of monopoly references is thus dealt with more quickly.

The decision-making processes and institutional arrangements are also reformed. Figure 8.1 demonstrates the procedures in some detail. In dealing with prohibitions the DGFT will either receive a request for guidance from businesses about activities that might be in breach of the prohibitions; a decision about a particular activity from a firm, including an exemption; or receive a complaint about anti-competitive behaviour. After investigation, the DGFT decides whether an activity represents a breach of the prohibition. An appeals procedure is to be established under the Competition Commission. This will have the power to review the substance of the DGFT's decision and the level of fine. Ultimately, a party has the right to appeal to the High Court on a point of law or the level of a fine. There are also powers to third parties affected by anti-competitive behaviour, including consumers. They can take their grievances against a DGFT decision to the Competition Commission. Where an infringement of the prohibitions has been proven they can claim damages in the High Court.

A few decisions have been made by the DGFT since the inception of the legislation. Most notable have been the case of Napp Pharmaceuticals (see Table 8.6) which has been charged with predatory pricing practices in the supply of sustained release morphine to hospitals and to pharmacies in the community (DGFT, 2001). The case of the UK indicates the process of legislative change in the field of competition policy but more time has to pass before judgement can be passed on the effectiveness of the new UK competition legislation. As with EC legislation it is likely that cases against an abuse of a dominant position will be difficult to prove and that raises the problem of whether it is worthwhile. In the UK the remnants of the Fair Trading Act 1973 have led to

TABLE 8.4: Key differences between the current and new regimes in the UK

	PRE-MARCH 2000 REGIME	NEW REGIME
Anti-competitive agreements		
<u>Basis</u>	<ul style="list-style-type: none"> * Restrictive Trade Practices Act 1976 (RTPA), Resale Prices Act 1976 (RPA), for restrictive agreements, cartels etc 	<ul style="list-style-type: none"> * Repeal of RTPA and RPA (and winding down of Restrictive Practices Court). Introduction of prohibition based on Article 81
<u>Process</u>	<ul style="list-style-type: none"> * Agreements filed under the RTPA placed on a public register (subject to any confidentiality granted by Secretary of State). Director General of Fair Trading (DGFT) asks Secretary of State (SoS) to agree insignificant cases should not go to Court. Significant cases referred to Court * Provisions in breach of RPA are prohibited, unless exempted 	<ul style="list-style-type: none"> * DGFT decides if prohibitions infringed and, if so, level of fines etc. * Beneficial effects assessed by DGFT for exemption * Appeal to new Competition Commission
Abuse of market power		
<u>Basis</u>	<ul style="list-style-type: none"> * Competition Act 1980 * Scale and complex monopoly provisions of Fair Trading Act 1973 (FTA) 	<ul style="list-style-type: none"> * Repeal of (most of) Competition Act 1980 * Retention of complex and scale monopoly provisions of FTA * Scale references only for tackling market power after proven abuse under prohibition * Introduction of prohibition based on Article 82
<u>Process</u>	<ul style="list-style-type: none"> * Alleged anti-competitive behaviour (abuse of market power) can be referred to Monopolies and Mergers Commission (MMC - now Competition Commission). MMC decide if against public interest or not. SoS makes final decision on remedies if MMC find against public interest 	<ul style="list-style-type: none"> * DGFT decides if prohibitions infringed and, if so, level of fines etc. * Appeal to new Competition Commission
Both		
<u>Criteria</u>	<ul style="list-style-type: none"> * Public interest test 	<ul style="list-style-type: none"> * Test based on effect on competition
<u>Investigation</u>	<ul style="list-style-type: none"> * Limited investigatory powers 	<ul style="list-style-type: none"> * Strong investigatory powers, including forcible entry/search powers
<u>Fines</u>	<ul style="list-style-type: none"> * No penalties for past behaviour 	<ul style="list-style-type: none"> * Penalties of up to 10% of UK turnover including for past behaviour
<u>Third Parties</u>	<ul style="list-style-type: none"> * Limited rights. Damages possible for breach of RPA or filing out of time under RTPA 	<ul style="list-style-type: none"> * Third party rights to challenge companies and seek damages
<u>Interim measures prior to completion of investigation</u>	<ul style="list-style-type: none"> * Only available under RTPA 	<ul style="list-style-type: none"> * Alleged anti-competitive behaviour may be halted during investigation

Source: DTI (1997)

Table 8.5

First fines for cartel activity

Bus companies found to have shared routes in Leeds

Two national bus companies have broken competition law because their subsidiaries based in Leeds and Wakefield agreed to share routes between themselves.

The OFT has set penalties for Arriva plc of £318,175 and FirstGroup plc of £529,852. Both penalties have however been reduced under the OFT's leniency programme where businesses blow the whistle or co-operate from an early stage.

This is the first infringement decision concerning an anti-competitive agreement made by the OFT under the Competition Act 1998, which came into force in 2000.

Staff of subsidiaries in Yorkshire of Arriva plc and FirstGroup plc met in a hotel room and agreed that Arriva would withdraw its five buses from two complete routes leaving FirstGroup with no competition on those routes. In turn FirstGroup withdrew from two routes that Arriva took on. Both businesses accepted that their staff had attended meetings and had agreed who would run certain routes.

Deterrence

While the scope of the agreement was not large, a substantial sum – over £0.5 million between the two companies – was included in the financial penalty for deterrence. The OFT regards deterrence as vital in combating cartels.

Leniency

When businesses act as whistleblowers on a cartel or co-operate at an early stage of an investigation, the OFT can grant leniency, which can result in financial penalties being reduced by up to 100 per cent.

FirstGroup plc asked for leniency first and at an early stage of the investigation, and it was granted 100 per cent leniency subject to it co-operating fully. As a result, it will not have to pay any financial penalty.

Arriva plc also benefited from the leniency programme, but only to the extent of a 36 per cent reduction making a total financial penalty of £203,632.

John Vickers, Director General of Fair Trading, said:

'Running a cartel is a serious breach of the Competition Act and undermines competition. Both companies co-operated in this investigation and benefited from our leniency programme. This can be a very effective means of obtaining information about cartels. The case shows that the full benefits of leniency are only available to the first one through the door.'

Source: Press Notice, 06/02 30 January 2002, Office of Fair Trading, <http://www.offt.gov.uk>

Table 8.6

OFT competition ruling upheld - decision saves the NHS £2m a year

The Competition Commission Appeal Tribunals have upheld an OFT ruling that Napp Pharmaceuticals had abused its dominant position. The Tribunals, however, reduced the penalty imposed from £3.21 million to £2.2 million.

The case was the first finding by the OFT of a breach of the Competition Act 1998 and the first financial penalty set by the OFT under competition law.

The OFT ruled in March 2001 that Cambridge-based Napp had supplied a drug used by cancer patients, sustained release morphine (trade name MST), to patients in the community at excessively high prices while supplying hospitals at discount levels that blocked competitors. Community prices were typically more than ten times higher than Napp's hospital prices and up to six times the export price of MST. During this period at least one competitor withdrew from the market.

Napp's conduct was judged to have infringed Chapter II of the Competition Act 1998, which prohibits abuse of a dominant position in a market if it may affect trade within the UK.

In addition to the penalty, the Tribunals have reinstated a direction made in May 2001 by the OFT requiring Napp to bring the infringements to an end, in particular by:

- reducing the price of MST tablets to the community
- limiting the extent to which discounts can be offered to hospitals.

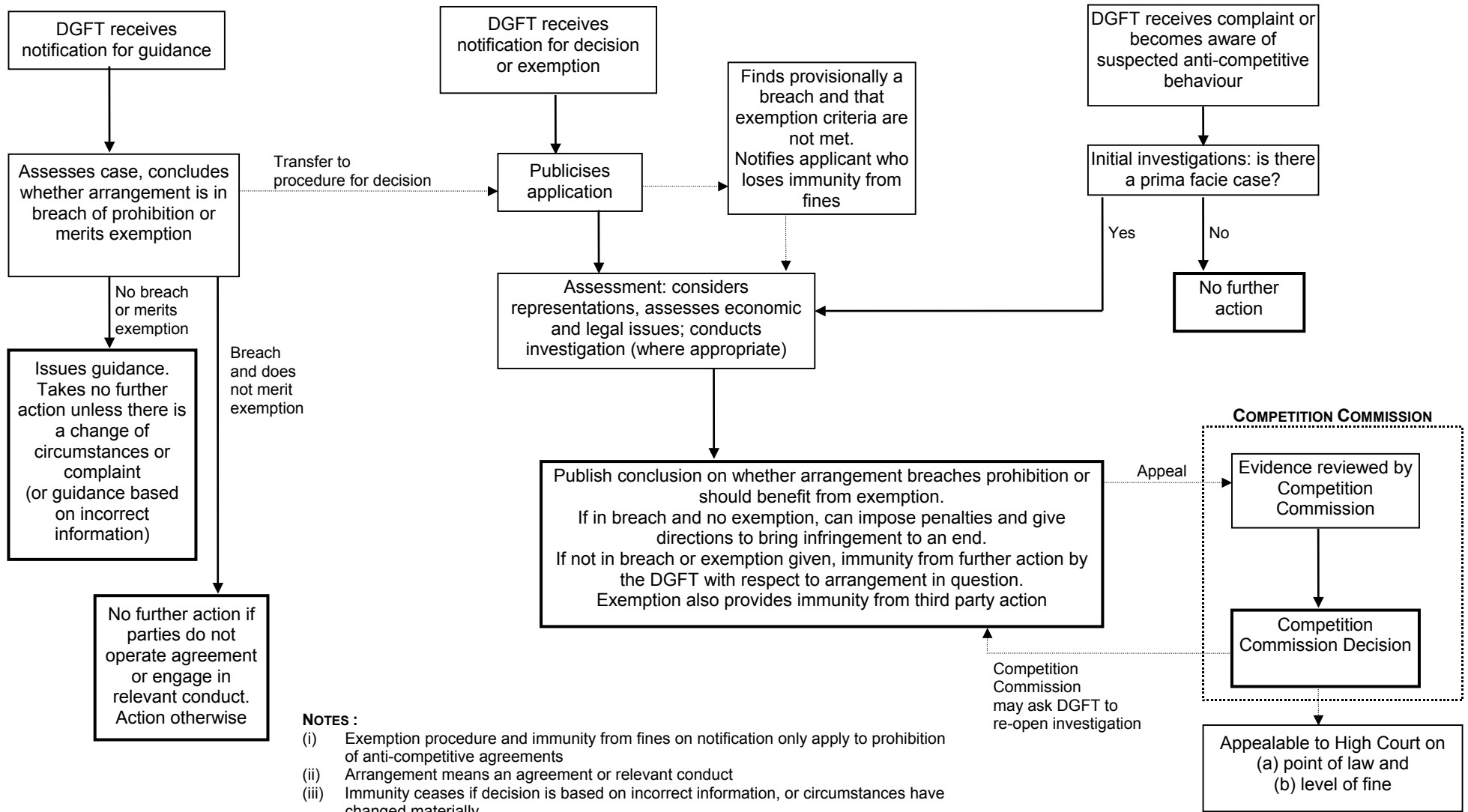
These measures will ensure more competition and lower prices overall.

John Vickers, Director General of Fair Trading said:

'Today's landmark ruling upholding the OFT's decision shows how competition law benefits the public - the ruling saves the NHS around £2 million a year. The OFT will continue to use its powers firmly but fairly to remove anti-competitive behaviour from the UK economy.'

Source: Press Notice 03/02 15 January 2002, Office of Fair Trading, <http://www.offt.gov.uk>

Figure 8.1: The decision making process in UK 1998 Competition Act (Source: DTI (1997))



- NOTES :**
- (i) Exemption procedure and immunity from fines on notification only apply to prohibition of anti-competitive agreements
 - (ii) Arrangement means an agreement or relevant conduct
 - (iii) Immunity ceases if decision is based on incorrect information, or circumstances have changed materially
 - (iv) Sector regulators will also apply the prohibitions in the same manner as the DGFT

8.4. Summary and Final Thoughts

In this chapter we have noted a range of views as to whether competition policy should or should not exist. For some economists it should exist to create the right environment in which firms can compete but the general consensus is that an additional element of competition policy should cover agreements or the abuse of a dominant position. To this extent we examined EC and UK competition legislation and presented case studies to demonstrate the actions of firms and the policy process.

The question remains whether how much regulation is needed? What is the point where the marginal costs of competition policy equate with the marginal benefits? Governments are sensitive to this but find it difficult to assess quantitatively. We noted, for example, how there had been constant calls to change UK competition legislation from politicians, consumer groups and some academics. Hard evidence though was slow in coming forward though it did indicate a need for change. Shaw and Simpson (1986), examining the period 1959 to 1973, showed that there was no significant difference in the change to market shares of dominant firms in UK markets investigated by the Monopolies and Mergers Commission (MMC) and a similar group who had not. Evidence from Davies *et al* (1998) showed that remedies imposed by the MMC on firms who were investigated under the 1973 Fair trading Act over the period 1973 to 1995 had a more limited impact in the 1990s than in the 1970s or 1980s.

The introduction of the 1998 Competition Act was clearly a fundamental change in UK establishing clear punishments for infringements. It has also led to a process of evaluating competition policy. Thus, there was an assessment of the regulatory burdens associated with its new 1998 Competition Act (DTI 1998) and more recently the Department of Trade and Industry commissioned an independent peer review of the UK Competition Policy regime (DTI 2001). Whilst this process is to be welcomed it does not resolve the debate as to whether there is too much intervention. The former evaluation showed how there were substantial benefits in controlling the abuse by large firms in spite of the additional compliance costs that would have to be borne by organisations in coping with the new law. However, the figures used to assess the compliance costs of the 1998 Competition Act could be open to interpretation and indeed the statement used to suggest the size of the welfare losses associated with dominant firms in this same document was based on the structuralist or behaviourist view of competition noted above and took little or no notice of the many economists who do not believe dominant firms to be welfare depleting (DTI 1998, pp. 11-13). The second evaluation of UK competition policy showed how the UK measures up to its Public Service Agreement target of having "the most effective competition regime in the OECD". The answer, incidentally, is that it fared well, coming in the top half of the league as ranked by peers (economists, lawyers, officials -except those from the UK- and representatives of company and consumer organisations), though it was below the USA and Germany. Moreover, a critical evaluation of the 'peer review' approach would note that there is a supposition that these regimes offer an appropriate level of regulation because there is no comparison with countries that offer lower levels of intervention. The point being emphasised here is that whilst competition regulation is growing governments are still never quite sure as to whether it is one step too far, or indeed, whether a complete reversal of the direction of competition policy towards significantly less intervention would be better for society in the long run. As we noted in chapter 5 vested interests can continue to increase the size and scope of regulation because it is in their remit to ensure that it does.

Activity

Go to the following search engine on the internet: <http://www.google.com> and type in the following "competition policy"+"china". Examine one or two documents in relation to Chinese Competition Policy and consider the nature of their measures. How do they compare to those in the EC and UK? Why not write some of your findings on the discussion forum for this chapter?

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Chapter 9

European Merger Control.

9.1. Introduction

In this chapter we are going to explore the current trends and rationale for mergers in the European Community. In particular we are going to examine the trends for such mergers and acquisitions in recent times, analyse some of the welfare issues and consider how the European Competition authorities deal with such mergers. Case studies are presented to show some of the complexities involved in dealing with competition problems and conflicts with the nation state. Thus, in dealing with mergers, the European Community is acting as a supranational authority with powers to shape the structure of European industry through its legislative powers and investigatory process. Such powers have a bearing on the economic welfare of European consumers and are subject to Type I (false positive) and Type II (false negative) errors. In other words, in allowing a merger to take place investigators may have unwittingly allowed a potentially anti-competitive firm through its net. Alternatively, and some may argue more worryingly, investigators ban a potentially useful merger. Under such circumstances the authorities will have to be very sure when they ban a merger and have in place other legislation to capture any future recalcitrant behaviour by the firms concerned. This also suggests that the number of prohibited mergers would be low which is indeed the case. However, as we will show towards the end of this chapter the policy making process is continuing to explore new possibilities of alliance activity by firms that may raise problems of incompatibility with the creation of a common market and so extend the legislation. This, of course, raises the question of what are the limits of regulation for merger activity.

9.2. Broad Trends

Put very simply mergers usually involve the cooperative joining of two companies, that is the majority owners of the parties concerned have made an agreement that it would be in their interests to combine activities and operate as one. An acquisition, on the other hand, involves some degree of resistance by the target company and that an exchange of shares usually has to take place via the stock market in order for the transfer of ownership to be successful. A joint venture usually involves the creation of a separate company to which the parents will seek either some or no control. These three activities are an important aspect of the competitive process and can help to shape the nature of industry. They may also lead to concerns for policy makers if they do not lead to the sort of prosperity that might be expected, largely because they lead to anti-competitive effects or to the re-direction of industry in a way that is not perceived to be in the interests of those citizens whose jurisdiction the merger falls under. Most countries have their own merger and acquisition policy and for those countries who have signed up to the Treaty of Rome and its subsequent amendments a supranational regulatory agreement is in place – The Merger Regulation EC 4064/89 amended by Council Regulation EC 1310/97 which represented a streamlining of the regulation in anticipation of possible developments arising from the introduction of the Euro and thus economic integration. We will say more about the policy later. For the moment we concentrate on the data.

Much of the data is self-explanatory but I shall comment on trends in this section and sectoral issues in the next. Table 9.1 shows very clearly that mergers, acquisitions and joint ventures (M and A) are fairly volatile. In a sense this is because M and As take time and recording the information will involve some fluctuations around the economic cycle. However, more general evidence does point to growth in M and As in the upswing of the economic cycle, perhaps indicating that company profits can be spent on new investments, and falls at times of depression (though, of course, there may be some bargains buys). Table 9.2 indicates how important merger activity is to particular European countries. Clearly, it is very important to nations such as Germany, France, the UK and Ireland.

Table 9.1 Evolution of M&A involving EU firms

Year	Number	% change
1991	8236	
1992	8000	-2.9%
1993	7327	-8.4%
1994	8006	9.3%
1995	8777	9.6%
1996	8087	-7.9%
1997	8382	3.6%
1998	10024	19.6%
1999	12796	27.7%

Table 9.2 Distribution of M&A activity and GDP between Member States, 1991–1999

Member State	Share of M&A activity (%)	Share of GDP (%)
B	2.80	3.2
DK	2.54	2.1
D	16.54	28.4
EL	0.67	1.4
E	4.84	6.9
F	14.38	18.1
IRL	1.58	0.8
I	6.39	12.7
L	0.47	0.2
NL	6.90	4.9
A	1.91	2.7
P	1.06	1.3
FIN	4.15	1.6
S	5.34	2.8
UK	30.45	13.0
EU	100	100

Note: In calculating this table, cross-border intra-Community operations are

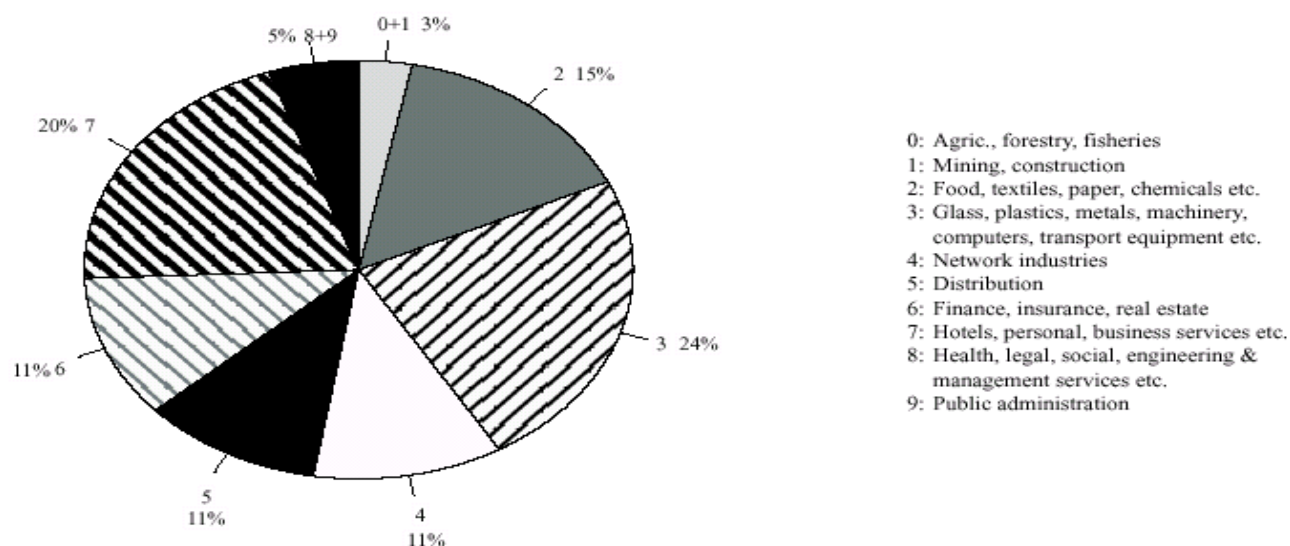
Table 9.3¹¹: Sectoral breakdown of cross-border M&A operations with an EU target, 1998–1999

Table 9.4 Most targeted sectors in M&A operations where the target is a Community enterprise, in percent of total – 1996–1999

Sector	SIC 2	% total 1998–99	% total 1996–97
Business Services	73	14.66	9.10
Real estate	65	5.80	3.24
Wholesale – durable goods	50	4.39	4.85
Industrial machinery & equipment, including computers	35	4.07	4.95
Food and kindred products	20	3.74	4.58
Engineering and management services	87	3.73	3.51
Printing & publishing	27	3.42	3.98
Chemicals and allied products	28	3.40	4.24
Electronic and other electrical equipment	36	3.19	3.42
Communication	48	3.03	3.01
Holding and other investment offices	67	2.80	4.30
Wholesale – non-durable goods	51	2.77	2.69
Banking (depository institutions)	60	2.10	2.33
Electric, gas and sanitary services	49	2.09	2.00
Fabricated metal products	34	2.03	2.19
Transport equipment	37	1.94	2.14
Transportation services	47	1.59	1.50
Instruments and related products	38	1.57	2.21
Hotels and other lodging places	70	1.57	1.54
Insurance carriers	63	1.49	2.35

Table 9.5 Types of merger by target sectors (target EU, cross-border + national) 1996–September 1998

Targeted sector	SIC 4	Horizontal	Vertical upstream	Vertical downstream	Conglo-merate
Wood, building materials	6130	46.4%	22.4%	3.2%	28.0%
Motor vehicles/parts	6148	43.8%	17.5%	8.8%	30.0%
Textiles	6160	40.9%	27.3%	4.5%	27.3%
Agricultural	6110	38.5%	11.5%	3.8%	46.2%
Machinery/Industrial Equipment	6149	37.7%	23.2%	1.6%	37.5%
Food & drink	6170	37.1%	26.3%	8.9%	27.7%
Others	6190	32.9%	–	–	–
Households goods	6150	29.9%	19.7%	6.8%	43.6%
Pharmaceutical	6180	29.8%	35.1%	1.8%	33.3%
Fuels, ores, ...	6120	25.8%	33.5%	1.9%	38.7%

9.3. Sectoral distribution of Mergers in the European Union

Tables 9.3 to 9.5 above show some interesting sectoral trends. Reflecting the general trend of Merger and Acquisition activity, industry accounts for a steadily declining proportion of cases dealt with under the EC's Merger Regulation. In the period 1991–1993, industry's share was 61%, while in 1996–1998 it was only 52%. Almost all of the remainder related to service sectors, the number of cases in the construction sector being very small.

Because the Merger Regulation (see below) applies only to operations involving firms with a very high turnover, notifiable operations are heavily concentrated in sectors where the average size of firms is large, such as chemicals, electrical equipment, telecommunications, banking and insurance. Hence we find, for example, that the chemical industry accounts for 10% of Merger Regulation cases compared to only 4% of operations recorded by AMDATA, the source of EC statistics. The disparity is even more striking in the post and telecommunications and insurance sectors. Comparing the first three full years of implementation of the Merger Regulation with the last three years, The Commission found that the relative importance of the chemical industry has remained steady at 10% of all cases. The food industry, on the other hand, now accounts for a much smaller proportion of cases than in the early days of the Regulation, having declined from 9.7% to 3.2%. The shares of cases in the electrical and optical equipment and motor vehicles sectors have also fallen substantially.

Privatisation and liberalisation in the network industries have led to a large increase in the number of cases in the electricity, gas, post and telecommunications sectors. In the first two sectors, there were no cases in 1991–1993 but 13 cases in 1996–1998 (2.6% of the total). In post and telecommunications, the number of cases rose from 5 in 1991–1993 (2.9% of the total) to 44 in the last three years (8.8% of the total). In the other service sectors, the share of banking has fallen from 8.6% to 7%, while that of insurance has remained stable at about 6%. Surprisingly, given the increase in the overall level of M&A activity in this sector, the number of cases in the business services sector was no greater in 1996–1998 than in the earlier period: 8 cases in both periods. As a proportion of the total, business services fell from 4.6% to 1.6%.

9.4. What factors are affecting these trends?

We already noted above how the broad trends are influenced by changes in the economic cycle. There are a number of other factors that could explain what has been happening over time to mergers and acquisitions. The European Commission economists have suggested the following and these may have some bearing on the sectoral distribution.

a) Interest Rates and Price Earnings Ratios

First, it may be related to long term real interest rates because it is cheaper to borrow when interest rates are falling. It may also be that merger activity increases because large rises in the average price earnings ratio (PER) is likely to be accompanied by a substantial increase in the variation in PER between individual firms. The result is that firms with a high PER may find it attractive to acquire the undervalued firm by means of a 'share swap'. Similarly, cross border variations in PERs may have an affect on acquisitions in that lower relative levels of PER in a country would be associated with a larger number of firms being targeted by overseas companies. There have also been studies showing a correlation between share prices and mergers in the UK and USA over time and so the EC economists tested this hypothesis too. In all cases they found no support for the change in merger activity over time.

An interesting issue is whether monetary union is having an effect on merger and acquisition activity. The single currency may have two affects. First, it can be expected to lead to higher levels of integration of product and service markets in general to take account of opportunities to reap economies of scale or defend domestic markets against increased cross border competition. Second, the greater integration of financial markets may make it easier for firms situated in the euro-zone to raise the capital needed to acquire overseas companies.

If the first effect is significant, it should reveal itself in a comparison between operations targeting the euro-zone and those targeting Member States not currently in the Euro-zone. These integration effects were seen in the run up to the Single Market. However, the growth rate of operations

targeting firms in the Euro-zone only exceeded that of operations targeting other Member States for the first time since 1995. So the evidence is rather limited.

The effect of finance should manifest itself in an increase in the number of acquisitions by Euro-Zone firms relative to that of other EU firms. Whilst this is true there is only one years evidence to this effect.

Explaining PER motives

The argument here is that 'the whole is worth more than the sum of the parts'. Suppose a large conglomerate firm, XYZ, has a price/earnings ratio for its stock of 20, but a small target firm, ABC, has a much lower price/earnings ratio of 10. If the annual profits (earnings) of ABC are £10 million, then its current stock value is $10 \times £10 \text{ million} = £100 \text{ million}$. If the annual profits of XYZ are £500 million, its stock value is £10 billion. If XYZ acquires ABC its earnings rise to £510 million and its stock market value rises by £200 million to £10.2 billion. Suppose XYZ offers to pay £125 million for ABC. Both shareholders are better off.

Of course, this requires stock market myopia – that is, even in the absence of any real benefits the stock market believes the conglomerate will improve the performance of the acquired firm. The problem comes when a growing firm continues in this way. Eventually the firm's record of achievement will come under scrutiny.

b) EC policy developments and Globalisation

The development of the internal market programme since the passing of the Single European Act in 1986 has led to a re-positioning of firms in the EU. Globalisation and the creation of the Euro zone have hastened these developments in more recent times (see European Economy Supplement A, various editions). As a consequence there has been an increase in cross border acquisitions from within the EU and from overseas.

Indeed, European Economy shows that the motives for the mergers have changed since the mid-1980s:

- diversification, rationalisation and synergies are less important now than
- Expansion and the strengthening of market position.

Thus firms in the EU are carrying out strategic asset seeking. An EC study addressing efficiency gains and competition losses across the EU shows that there are still enormous efficiency gains to be made in (e.g. technologically dynamic) industries where reduction in competition from merger is slight. However, there are also mergers, acquisitions and joint ventures that the Commission should be wary of.

What's behind merger efficiency?

Economies of scale are often cited as an efficiency rationale for (mainly horizontal) merger. The market for corporate control (the stock market) affords good managers the opportunity to acquire companies that are under performing (that is X-inefficiency is seen to exist). However, the Continental European market for corporate control facilitates merger rather than hostile takeovers because of the organisational make-up of the firms concerned. With economies of scale the merged firms should achieve lower unit costs. What though is the evidence on scale economies from post-merger studies?

A study by the Berlin based International Institute for management covering a 10 year period and 765 merger cases in Belgium suggested that mergers do not result in lower prices, improved efficiency, etc but are merely carried out so as to "build empires" (see El Agra, 1994). However, as we note in the main text the European Commission economists do see some sectors – the technologically dynamic ones – where there may be some cost efficiency savings.

Another reason often cited for mergers is that they improve **investment in technological capacity** over the long haul. Here synergies between companies are often perceived to be influential in the development of an organisation's core competences. Sharing technological expertise may also lead to the establishment of joint ventures between companies where the research and development costs are prohibitively high for the individual firm.

One of the classic reasons for efficiency through vertical integration is **transaction costs**. For example, manufacturers may acquire wholesale companies when they wish to enter a new geographic market but experience difficulty in establishing suitable distribution arrangements. In such circumstances, the acquisition of a wholesale company already established in the target market may be the best way to enter the market. In these circumstances the argument is that the costs of using the market (i.e. finding a suitable wholesaler and working with them) are too high and the only solution appears to be to bring in a suitable partner with

Risk Reduction. Pure conglomerate mergers are the most likely to reduce risk because they indicate diversification into areas where interdependence between products is lowest.

9.5. Market Power Issues

To consider whether a merger has any competition effects the principle sectors of activity of the firms concerned can be examined. Thus, mergers can be grouped as follows

Horizontal - mergers between firms in the same four digit sub sector.

Vertical – mergers between firms in sub-sectors that are linked by an important supply relationship (e.g. wholesale and retail food and drink)

Conglomerate – mergers between firms in different sub-sectors with no evident vertical link (i.e. they are largely about diversification).

Table 9.5 shows that in those growth sectors where some distinction is possible horizontal integration is more likely. However, vertical integration, particularly upstream vertical integration is more relevant in sector 83.

All types of Merger can increase market power. Horizontal mergers lead to fewer firms in the industry and raise the concentration ratio (a measure of market share). This means that the possibility of an abuse of market power may develop although it is not a sufficient condition for such a development. Likewise vertical mergers can raise entry barriers, which may restrict potential competitors with providing viable alternatives to consumers, or it may facilitate collusion in downstream markets.

However, as we noted above they may improve efficiency and lead to greater choice for consumers through technological advancements.

Theoretically then mergers may be good they may be bad for economic welfare. We briefly examine the negatives.

a) Horizontal Mergers

Some of the following is based on NERA (1999 p.18).

There are three concerns regarding horizontal mergers. They have

- ❑ **Unilateral effects.** In effect they reduce the number of players in the market.
- ❑ **Co-ordinating Effects.** Here they may create an environment in which explicit or tacit collusion can develop.
- ❑ **Exclusionary Practices.** For example, it might be feared that the merged firm would be better placed to engage in predation, anti-competitive discriminatory pricing, conditional discounting, full-line forcing or refusal to supply. Fear of exclusionary practices can arguably be considered a variant on the first concern.

One of the most frequently heard defences of a merger which involves firms with apparently high market shares is that the market is actually wider than it may initially appear and that consequently the increase in concentration is far less than it might have seemed.

Market definition arguments aside, horizontal mergers that generate a significant increase in market concentration and consequently raise fears of unilateral or co-ordinated effects may be defended on two grounds.

- ❑ First, it may be argued that concentration measures alone are an inadequate guide to the impact of the merger on competition and that there are other factors that will ensure that the merger is unlikely to lead to reduced competition and higher margins for the merging firms.
- ❑ Second, it may be argued that even if the merged firm can widen margins following the merger, the merger creates other benefits that will offset this, such as cost savings, and these may lead to lower prices, despite wider margins.

b) Vertical Mergers

What is important is the existence of market power in at least one of the markets (upstream and downstream). If both markets were competitive increased vertical integration and foreclosure would have no negative impact on efficiency, because the prices in both markets would equal marginal cost regardless of the degree of vertical integration. In addition because of the problem of '**double marginalisation**', if both firms had monopolies in their respective markets (bilateral monopoly) vertical integration would have a positive effect on efficiency.

Note, however, that vertical integration can raise the capital barrier to entry, result in price squeezes and facilitate collusion.

c) Conglomerate Mergers

Conglomerates may encourage **reciprocity** among their divisions to the detriment of smaller, independent sellers. They may engage in **cross-subsidisation** and they may create an atmosphere of **economic forbearance** whereby two companies in (say) the computer business may give each other an easy time for fear of retaliation in the car market where they also compete.

9.6. EC Policy on Mergers

Merger Control Regulation (EC 4064/89 amended by EC 1310/97) originally arose out of dissatisfaction with the application of Articles 85 (now Art. 81) and 86 (now Article 82) of the Treaty of Rome with respect to mergers.

The latter involves an *ex post* analysis but there was a need to have *ex ante* investigations into the likely future position of merging parties and market conditions to fulfil the idea of the Common Market. This is an important distinction with previous attempts to control mergers for the EC is now looking to examine the evolving structure of the market post-merger. Thus the Commission is now actively engaged in analysing whether mergers could lead to anti-competitive (welfare reducing) behaviour. The 1989 regulation was also introduced to ensure that the creation of the single market from 1993 went smoothly and that firms would re-position themselves strategically to provide goods at lower prices rather than to deter competitors from newly emerging by raising entry barriers or acting in an anti-competitive manner. Similarly, the amendment to the regulation in 1997 was to forge the way for a new wave of mergers anticipated in the light of the development of the Euro and the single currency.

Since 1989 when the regulation was introduced an EC task force must vet mergers, takeovers and Joint Ventures that meet certain criteria. They must discover whether the

- merger/takeover/ joint venture creates a concentration

(i.e. arrangements whereby one or more undertakings acquire control of an undertaking and thus change the structure of companies and the market they operate in.)

- merger/takeover/joint venture has a community wide dimension

(i.e. a concentration with world wide annual sales of ECU **ECU 2.5 bn** and if EC wide sales are at least ECU **100 million**. One exception is if each party derives over 2/3's of its sales from one and the same country. In such circumstances the national competition authorities must deal with the merger. Note 2 U.S. firms could come under this legislation if EC-wide sales are greater than **ECU 100 million**.)

- joint venture increases concentration or involve cooperation.

Originally the regulation covered concentrative joint ventures, which is where two or more parent companies transfer their existing business into a joint venture and then exit the market. However, cooperative ventures (where the parents remain active in neighbouring markets) raised anti-competitive issues and took longer to process. This encouraged the parties to look to changing the status to concentrative. However to overcome this an important amendment now relates to **full function co-operative joint ventures**. This is where more than one of the parent companies remained on a market. These parents could operate as an independent entity and can be upstream, downstream or neighbouring the joint venture. Their presence could suggest dominance in the market, e.g. through the co-ordination of activities. At the moment these are in the e-commerce and telecommunications industry and represent an important development for knowledge based industries in the EU but thus far the Commission has not sought to prohibit such activities.

Procedures

No concentration may be put into effect before notification or within 3 weeks following notification.

Phase 1 ends after 4 weeks whereby the Commission makes a decision as to the concentration's compatibility with the common market.

If there are serious doubts about compatibility Phase 2 comes into effect and a 4 month investigation takes place.

Failure to abide by a Commission decision may lead to fines up to 10% of turnover of the undertakings concerned.

The Commission's decision is final though the Court of Justice acts as the body of appeal.

How does the Commission evaluate?

A distinct procedure has emerged for assessing notified mergers once Community jurisdiction has been established.

1. determine the relevant product market
2. determine the relevant geographical market
3. assess whether a merger creates or strengthens a dominant position

Four elements are examined:

1. the market position of the merged firm (market share and other competitive advantages)
2. strength of the remaining competitors
3. customers' buying power
4. potential competition

Market shares are usually the starting point for assessment of dominance. Thus far the regulation is presumed to have no bearing on situations where market dominance is 25% or less. No reactions to a merger creating less than a 40% market share have occurred. However, every merger with a market share above 60% has at least triggered a Phase 2 Procedure.

The Commission has thus been concerned about oligopolistic as well as purely monopolistic dominance. Few of these have so far been drawn to the attention of the Commission. However, in the Nestle/Perrier merger the regulation was applied.

There are differing views about market shares according to the market under investigation: stable market shares over time and gaps between merged firms and the nearest rival point to market power; dynamic markets characterised by high rates of technological development are less entrenched.

Some, of course, would argue that there is no need for a policy; we should allow the market to develop unfettered. Mergers are thus about entrepreneurial endeavour. Collusive and monopolistic behaviour will break down.

Notifications under Merger Control Regulation

From the time the regulations took effect until the end of 1999 1292 notifications have been made (49% were JVs, 39% were acquisitions of majority holdings). The breakdown is as follows:

- 1027 cleared at phase 1(45 with undertakings)
- 51 withdrawn
- 51 fall outside the scope
- 9 full referral back to national authorities
- 58 required a phase 2 examination

Of the latter

- 36 have been seen as compatible if certain conditions and obligations were met.
- 11 were seen as compatible with the European Treaty and allowed without obligations.
- 11 have been prohibited
 - Aerospace/De Havilland (1991)
 - MSG Media Service (1994)
 - Nordic Satellite Distribution (1995)
 - RTL/Veronica/Endemol (1995)
 - Gencor/Lonrho (1996)
 - Kesko/Tuko (1996)

Saint Gobain/Wacker Chemie/NOM (1996)
Blokker/ Toys 'R' Us (1997)
Bertelsmann/Kirch/Premiere (1998)
Deutsche Telekom/Betaresearch (1998)
Air tours/ First Choice (1999)

Some Phase 2 cases that were allowed

Hong Kong and Shanghai Bank/ Midland (1992)

This case is interesting because it raises issues over competing jurisdictions. Once a bid by Lloyds Bank had been rejected by Midland HKS resurrected a merger plan that had collapsed in 1990. While the European Commission was bound to investigate the HKS bid the Merger Control regulations meant that the UK Monopolies and Mergers Commission (MMC) was equally bound to investigate any Lloyds bid, and both bodies might have chosen to investigate both bids. Indeed, it would have been sensible to have both bids examined simultaneously and given the overriding domestic considerations (accentuated by the fact that HKS's European assets were largely in the UK) suggests that primacy of jurisdiction should be accorded to the UK's MMC.

Brussels cleared the HKS bid arguing that HKS and Midland compete in very few sectors. Such a clearance prevents national regulators from undertaking an additional investigation other than under the exceptional circumstances outlined in Article 21 of the Treaty of Rome (which includes prudential banking rules as well as national security and media interests). The Bank of England did not deem such action appropriate in this case.

The Lloyds bid for the Midland was referred to the MMC a little after the Commission had initiated an inquiry into the HKS and Midland. After an appeal to the US Federal Reserve to invoke American banking law as a means to block the HKS bid failed, Lloyds withdrew its bid.

Unfortunately, this meant that the issue of overlapping jurisdiction was never put fully to the test.

Nestle/Perrier (1992/3)

Nestle put in a bid for Perrier supported by BSN, France's leading food manufacturer to whom it would sell Volvic. This would leave BSN with a share of the European mineral water market not far short of Perrier and hopefully protecting Nestle from monopoly proceedings.

Nestle managed to make a viable bid after lawsuits to take shareholding control away from the Italian Agnelli family. However, the Commission considered that Nestle and BSN would control some three-quarters of the French mineral water market. Elsewhere in the EU, however, neither company was thought to have more than 20% of any national market.

The Commission thus ruled that such a duopoly would be anti-competitive and ordered Nestle to sell 8 brands, about 20% of French capacity, to a single buyer before it buy Perrier. In 1993 the French Castel beverages company was persuaded to buy the 8 brands.

Price Waterhouse/Coopers and Lybrand (1998)

In 1998 the Commission also examined two planned mergers in the accountancy services sector, the first mergers ever notified in this sector. The first notification, concerning *Price Waterhouse/Coopers and Lybrand*, was shortly followed by the notification of a plan to merge *KPMG and Ernst and Young*. The sector as a whole is highly fragmented, consisting of many companies ranging from the very small to the very large. However, the Commission found that there is a distinct market for accountancy services provided to very big companies, mainly multinationals.

The providers of services to such companies must be able to offer a comprehensive service from a world-wide network of offices staffed by people with locally recognised qualifications and specialist expertise. There were only six significant competitors in this market and this number would have been reduced to four if both mergers had been carried out. However, the KPMG/Ernst and Young merger was abandoned after the Commission opened the Phase 2 procedure. The Commission therefore had to consider whether the Price Waterhouse/Coopers and Lybrand merger alone would create or strengthen oligopolistic dominance. The Commission found that the market presented some of the characteristics that are conducive to collective dominance, such as stagnant demand, little scope for innovation and transparent pricing. However, the merged entity would still face four large competitors and there was evidence that clients were willing and able to transfer their custom to other accountancy firms in order to obtain better terms. Furthermore, there was considerable asymmetry between the competitors. The merged entity was much larger than its competitors, although its market share would have been less than 40% in any Member State. There were also large differences in the market structure in different countries. These factors suggested that the cost structures of the firms in the market were highly asymmetrical, making it difficult to sustain anti-competitive parallel behaviour. **The Commission therefore approved the merger.**

Sources: Curwen and Gale (1993), European Economy Supplement A Feb 1999

9.7. Some of the Prohibitions

Aerospatiale-Alenia/de Havilland (1991)

The French state-owned Aerospatiale and Italy's state owned Alenia wanted to takeover de Havilland, the Canadian commuter turbo-prop subsidiary of Boeing. The French and Italians saw this as an industrial policy issue to establish national champions. The Commission judged otherwise.

The proposed takeover would have given the French/Italian JV 50% of the world market and 67% of the EU market for commuter turbo-props for 20-70 seats (slightly more in the 40-70 seat range). Curwen and Gale (1993, European Business and Economic Development) suggest that this would have probably driven out 2 private EU producers, B. Aerospace and Fokker of Holland.

Awkward issues:

1. There was growing competition from developing country producers
2. Developed countries were moving over to small aircraft such as those planned by Airbus Industrie and Daimler-Benz and this would have dramatically altered the market share figures.
3. In February 1991, a merger of Aerospatiale's helicopter business with that of Germany's Messerschmitt-Bolkow-Blohm was approved despite the resulting JV leading to a 50% market share in the EU civilian helicopter business.

NSD (1995):

A proposed Joint Venture between Norsk TeleKom, TeleDanemark (largest cable operators in Norway and Denmark) and Industriforvaltings AB Kinnevik (a Swedish conglomerate which inter alia produces and distributes TV programmes and interests in telecommunications).

The Commission found that the JV would create a strong vertically integrated industry and a dominant position in 3 markets.

- the provision of satellite TV transponder capacity to the Nordic region
- the Danish market for cable TV networks
- direct distribution of pay TV and other encrypted channels to households.

Entry to the satellite TV market would be foreclosed and so was incompatible with the Common Market.

RTL/Veronica/Endemol (1995):

Respectively, the Luxembourg broadcasting company, Dutch commercial TV company and largest independent producer of TV programmes in the Netherlands. This case did not meet the turnover threshold but was referred to the Commission by the Dutch Government. A JV called HMG was to be formed to which RTL would transfer its 2 Dutch TV channels and Veronica its TV channel.

The Commission considered that there would be a strong advantage of co-ordinating programming and that HMG would have a dominant position in the market for TV advertising. Further, the vertical link between HMG and Endemol would strengthen the latter's already dominant position in the Dutch Market for TV programme.

The Commission therefore ruled the merger incompatible with a common market.

Blokker/Toys'R'Us (taken from, *European Economy. Supplement A- Economic Trends, Feb 1999*)

The case of Blokker/Toys'R'Us 1997 did not have "a Community dimension" as defined in the Regulation but was examined by the Commission at the request of the Netherlands, which at that time did not have a national merger control system. The case concerned the acquisition by Blokker of six of the nine huge toyshops of Toys 'R' Us in the Netherlands. Blokker operated the other three shops temporarily pending their closure. Blokker is the market leader in toy retailing in the Netherlands. The Commission found that even before the operation Blokker already had a dominant position in the relevant market, defined as the Dutch retail market for toys sold through specialist shops and shops with specialist departments. Although the market share added by the acquisition was quite small, the Commission came to the conclusion that the acquisition strengthened Blokker's dominant position by giving Blokker access to large suburban retail outlets and by creating new barriers to entry into the market. The operation was therefore declared incompatible with the common market. As it had already taken place, the Commission ordered Blokker to sell most of its shares in the subsidiary formed to operate the Toys'R'Us shops to a company capable of acting as an effective competitor.

Bertelsmann/Kirch/Premiere and Deutsche Telekom/Betaresearch (taken from *European Economy, Supplement A - Economic Trends, Feb 1999*)

The prohibitions decided in 1998 occurred in two linked cases in the field of digital pay-TV: *Bertelsmann/Kirch/Premiere* and *Deutsche Telekom/Betaresearch*. The provision of a package of digital pay-TV services involves the following chain of supply: programming content, broadcasting facilities, access to cable or satellite facilities, "set-top box" technology (for decoding signals and recording details for charging purposes) and a number of related technical services. The two operations in question would have established structural links between the leading suppliers of all the elements of this chain in the German market. Premiere is one of only three pay-TV providers in Germany. The other two are DF1 and Canal+, which uses the technical platform of DF1. The Bertelsmann/Kirch/Premiere merger would have included the transfer of the assets of DF1, as well as Kirch's sports channel, DSF, to Premiere. Kirch has access to by far the biggest programme resources in Germany, notably pay-TV rights for Hollywood films and major sporting events, and also controls the "d-box" set-top box technology, which has been chosen by Deutsche Telekom for its cable network, the only cable network covering the whole country. The second operation would have given Deutsche Telekom joint control of Betaresearch, a wholly-owned subsidiary of Kirch, and with it the exclusive rights to the "d-box" technology for cable TV. Although there was no significant overlap between the parties in most of the product markets considered, the Commission forbade the mergers because they would have established vertical links which would have created or strengthened dominant positions in all the major links of supply chain.

Airtours/First Choice

The only prohibition in 1999 concerned the proposed acquisition by the British tour operator *Airtours* of its domestic rival *First Choice*. This was the first prohibition decision to be taken by the

Commission on the ground of the creation of joint dominance by more than two firms. The parties' activities overlap mainly in the supply of leisure travel services in the UK and Ireland. Both parties are tour operators and they are also vertically integrated into the upstream market of airline operation and in the downstream activity of travel agency. The Commission considered that the main impact of the merger would be felt in the market for short-haul foreign package holidays sold in the U.K. In this market, Airtours/First Choice and two other leading vertically integrated tour operators would have had a position of collective dominance. The combined shares of these three firms in the package holiday market would have been about 85%, while no other firm has a market share above 5%. The Commission found that there are significant barriers both to new entry into the market and to the expansion of smaller firms and that the merger was likely to raise these barriers. It considered that upstream and downstream vertical integration – ownership of charter airlines and travel agencies – gives the major tour operators a strong advantage. Vertical integration also increases the transparency of the market, because operators buy aircraft seats from each other and use each other's travel agency networks to sell their package holidays.

A peculiar feature of the market is that the supply of package holidays is largely fixed well before sales begin (up to one year in advance), when the operators reserve aircraft seats and accommodation. Thereafter, an operator can increase its supply by, at most, 10% until February of the year in which the holiday takes place. Moreover, the operator incurs substantial cancellation charges if it reduces the number of holidays offered. Supply is therefore quite inflexible once the selling season has begun. In these circumstances, major tour operators have a strong incentive to restrict supply rather than to compete aggressively to gain market share, because of the risk that the market will be oversupplied, leading to a sharp drop in prices and consequently to losses for all players in the market. The Commission considered that this risk would be significantly increased by the reduction of the number of major operators from four to three and, hence, there would be an even stronger incentive for the remaining three to adopt a common strategy of restricting supply.

9.8. Issues for the Future

The Commission is worried by

- the growth of oligopolistic dominance.
 - The completion of the internal market could leave important markets dominated by a few firms - especially in sectors like airlines and telecommunications where single companies have dominated national markets.
- the very high thresholds
 - some sectors are so small that a community wide monopoly would not attract attention under merger regulation.
 - Member states have varying attitudes to referral for mergers under threshold values.

This is why the Commission moved to lower thresholds in 1998 and is pressing for further reductions.

There are still problems given the volumes of mergers in the EU and the rapid development of full function co-operative joint ventures. These have important implications for technological developments in the EU and may well raise important competition issues. The EC attitude thus far has been to allow joint ventures without conditions.

In a sense the Commission is right to expect firms to change their approach to alliance activity as demand and supply conditions change. Possibly too the move towards lower thresholds may find merger activity that is incompatible with the formation of the common market. However, the current number of phase 2 investigations and indeed the number of prohibitions suggest that this may be an expensive activity. Perhaps this is a time to review the merger process in its entirety.

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