

CRA Competition Memo



Don't Throw Out Your Numbers

It frequently shocks business people just how little outsiders understand their industry. Usually this doesn't matter, but when those who lack understanding are competition policy enforcers the consequences can be serious. The power to prove mistaken ideas to be wrong is often critical for a company facing an investigation. In the UK, the provisions of the new Competition Act mean that the potential cost to a firm under investigation losing the argument in a competition case could be high: a firm could be fined up to 10% of its UK turnover.

The UK business community has not been short of advice from lawyers and economists over how it should respond to the new Competition Act and Lexecon does not wish to add unnecessary height to the mountain of paper on the topic. There is, however, a simple and cost effective response that affected firms can undertake themselves that could reap dividends in the future. Companies which have taken the trouble to compile market information stand at a distinct advantage relative to their competitors who do not. Put simply: don't throw out your numbers.¹

Why Data is Important

The new Act increases the pressure on firms under investigation to back up their arguments with empirical evidence. Agreements and behaviour are to be assessed on the basis of their economic effects rather than their legal form. The Act introduces two prohibitions. The first deals with anti-competitive agreements (Chapter I prohibition, which is modelled on Article 85). This requires an assessment of the economic effect of an agreement, which in turn is likely to involve (amongst other things) an appraisal of the relevant market. The second prohibition (Chapter II, modelled on Article 86) applies to firms who abuse a dominant position within the UK (or part of the UK). Once again, defining dominance requires an economic appraisal in which market definition would be a central issue.

The market definition framework is now well documented and we will not repeat it here.² Instead, this *Competition Memo* is concerned with outlining the data firms should collect in order to be prepared to quantify the economic effect of an agreement or defend (or indeed formulate) a dominance claim. The box

summarises the general categories of information which could be helpful.

Competition Database: Contents

Price Data
Quantity Data
Examples of Industry Shocks
Cost Data
Entry Case Studies
Market Share Data
Tender Analysis

Taken together, this information forms a basic 'competition database' which can be used at short notice. The components are described in turn below.

Start with Price Data

Price data is the most important information to preserve. This is hardly surprising, as most competition cases ultimately involve an assessment of whether prices either are already too high or are likely to rise. Price data also has the attraction of producing the most information for the least expenditure of effort. Both the European Commission and the OFT have accepted that certain quantitative techniques give an insight into the nature of competition in an industry and the most powerful of these techniques involve an assessment of prices.³ Examples include:

- **Price Elasticity Analysis**
This measures the responsiveness of demand for a product to changes in price. The more elastic the demand, the less likely is it that a price rise would be profitable.
- **Price Correlation Analysis**
This examines the extent to which the prices of two products move together. If the price of one good constrains the other, the two price series should move together.
- **Price Concentration Analysis**
This explores the degree to which higher levels of industry concentration coincide with higher prices.

We are not suggesting that such studies would be relevant to every competition inquiry or would be feasible in every industry. Much as many economists enjoy calculating price elasticities using advanced applied econometrics, the truth is that the availability of price and quantity data – and subsequently the scope

¹ The observations we make below concerning the merits of preserving data are aimed at those firms who have some expectation that their agreements or behaviour could merit investigation under the terms of the new Competition Act.

² The 'SSNIP test' was discussed in detail in a Lexecon *Competition Memo* in June 1997. The OFT issued draft guidelines in November 1998 which sets out the framework in some depth.

³ See, for example, paragraph 39 of the Commission *Notice* on market definition issued in December 1997 and paragraph 3.6 of the OFT draft guidelines on market definition. Note that the more sophisticated techniques also require detailed quantity data.

for undertaking sophisticated analysis – varies widely across industries.

In some sectors, high quality data is available from external sources which means that the techniques identified above can be undertaken. In many cases, however, there is no external data source available. In these industries, it is particularly important for the firms involved to preserve both their own internal price information and rival firms' price data. In a competition inquiry, a little data is much better than no data. Internal data on list prices, transaction prices and discount structures for each of the firm's products might all be useful if arguments are to be supported empirically at a later date.

Shock Analysis

One example of a technique which can provide powerful results with fairly rudimentary data is shock analysis. The idea is that a large unanticipated change in a market can provide the basis for a natural experiment. The departure of sterling from the exchange rate mechanism (ERM) in September 1992 is a good example. UK prices of goods fell relative to those in other European countries. This provided an opportunity to assess whether competitive pressure in a given industry would lead to the elimination of this price disparity. This is relevant as the potential threat from overseas entry is often cited by defendants in domestic competition cases.

However, many firms do not have data dating back from this period, which means it is not possible to use the ERM exit of sterling as a case study. Of course, this event is now over six years old. But the fact that many firms have not kept potentially helpful price data illustrates a crucial point: it is often not possible to know in advance what data would be helpful, so it is always preferable to err on the side of caution in preserving data. The ERM shock was unusual in that it affected a range of industries. Many shocks are industry-specific. Trade friction, technological change, health scares, severe weather, wars, tax changes and strikes are examples of shocks that might be industry-specific. Evidence compiled by firms in the aftermath of such a shock could well be useful in a future competition case.

Other Useful Data

In addition to price data, other useful information that firms can collate includes the following.

- **Cost Data**
Cost data can be crucial in explaining price changes over time. For example, showing that movements in prices mirror movements in input costs can provide powerful evidence to counter a dominance claim. Like price data, historical information on costs is often hard to retrieve at a later date.
- **Entry Analysis**
Information on how an incumbent's prices, output, advertising, costs and product positioning changed in response to new entry can provide a compelling insight into competitive conditions in a market. Case studies outlining previous entry can also be

used to assess the feasibility of new market entry.

- **Market Shares**
Market share data can be helpful in a number of ways. For example, volatility in market shares over time can be useful in fighting a dominance claim. Also, collecting market share data on a variety of alternative definitions of the market can provide useful evidence in assessing the relevant market.⁴
- **Tender Analysis**
The outcome of recent tenders in an industry can also give an insight into competition. For example, defending a dominance claim might require convincing evidence that smaller firms constrain prices. Tender analysis showing, for example, that smaller players can win tenders regardless of their market share can be helpful.

In public statements, companies usually want to make a virtue their success. In contrast, competition cases often depend on demonstrating the effectiveness of rival firms. Much of the information identified above is designed to quantify the competitive constraint imposed by other players in a market. This requires firms to compile information on their failures as well as their successes.

Conclusion

In considering whether to go to the trouble of setting up a competition database, companies should spare a thought for the competition authorities they might be dealing with. These bodies have only a short time to get to know the mechanics of an industry. Understanding a new industry in a matter of weeks is hard enough: it is rendered even more difficult if the data provided is inadequate or unhelpful. The examination of a case is made much easier if useful information can be presented at an early stage.

The creation of a competition database is a pre-emptive step which any firm can take by itself without incurring significant costs. The upside, in contrast, can be very high. Competition authorities are often swayed by evidence that seemed innocuous or irrelevant prior to the case. The analysis of competition cases has become increasingly empirical in recent years, and the new UK Competition Act is a move in the same direction. The new prohibitions are due to take effect in March 2000. This gives UK firms time to examine methods of internal data collection and setting up a database could be done in tandem with a legal compliance programme. Under the new regime, throwing out your numbers might prove costly.

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⁴ For example, Lexecon recently contributed the economic part of a legal and economic assessment of whether a manufacturer of branded products was exposed to the threat of a dominance claim. Using market share data on both 'premium product' and 'total product' bases, we used price/concentration analysis to show that there was little evidence to support a 'premium product' market definition.