

CRA Competition Memo



Meeting Competition

The Great Contradiction

At the heart of European competition law lies a fundamental contradiction. It arises in the following way. Frequently a dominant firm faces entry by new competitors and responds, as one might expect, by *meeting competition* with price cuts - sometimes selective, sometimes not. Thereupon the new entrant complains that the price cuts are anti-competitive because they are predatory, or discriminatory, or targeted at, and designed to eliminate, the new entrant.

The competition enforcers in Europe often support two incompatible propositions. On the one hand they affirm that selective price cutting undertaken by a dominant company is abusive if targeted at a new entrant. On the other hand, they affirm that when competition appears on the market a dominant company is entitled to meet it.

The Sweden Post Example

The seriousness of this incoherence is illustrated by a Swedish case which came to a climax just a few weeks ago when the Stockholm District Court partly annulled a series of decisions of the Swedish Competition Authority condemning the pricing policies of the Swedish Post Office.

Uniquely in Europe, the legal monopoly of Sweden Post was lifted in 1993 without the comfort of any 'reserved area' (the residual monopoly which is meant to ensure that postal operators are able to fund their universal service obligation). Yet by agreement with the State, Sweden Post remains under obligation to provide an affordable universal postal service in Sweden. Like all post offices, Sweden Post finds that mail which is shipped in bulk, especially for delivery to densely populated urban areas, is highly profitable. Sweden Post faced entry by a rival firm in exactly and only those areas. This is in line with economists' predictions of entry following liberalisation in markets where a historical uniform tariff masked significant variations in the underlying costs.

Sweden Post sought to meet the competition, hoping to preserve as much as possible of its bulk mail traffic, by devising tariffs that would lower the prices for delivery in Stockholm, Malmö and Gothenburg - the three big cities where the new competitor had entered at much lower prices. The new competitor complained that by pricing differently in the densely populated urban zones, Sweden Post was behaving anti-competitively. The Swedish Competition Authority broadly agreed with the complainant and prohibited Sweden Post from differentiating its prices, even

though there was broad agreement from all sides that Sweden Post was not predating.

When A No-Predation Rule is not Enough

One of the most attractive features of competition is described by economists as its *selection property*. Unregulated competition tends to select as survivors in the marketplace only firms with an appropriate business strategy, firms which are run efficiently. Predation rules in effect use this idea, though exact standards for the cost tests are the subject of continuing study and debate. Nevertheless the principle is not in doubt: an anti-predation rule will not allow a dominant firm to eliminate a more efficient rival.

However, this is not to say that meeting competition, even if not predatory, can never have disadvantageous consequences. Think for example of a dominant incumbent which sunk its fixed costs long ago and now stands ready to meet competition. Suppose this dominant incumbent is allowed to meet competition by pricing all the way down to marginal cost on each and every occasion on which any entrant appears anywhere. Then, even if the new entrant is just as efficient as the incumbent, the entrant could nonetheless never make a profit because he will never be able to recoup his sunk cost. Entry will always be a bad investment.

Driving Out vs Failing to Enter

This creates a policy dilemma. Cutting prices to meet competition is a normal and essential part of the competitive process. Nonetheless it can operate in harmful ways in those instances where it has the consequence that entry is effectively deterred, and consumer prices end up being kept persistently high.

The plea of abuse-of-dominance complainants is sometimes a plea to be relieved of the rigours of competition, and thus benefit from a measure of *entry assistance*. It is on the question of entry assistance that this issue really turns. An anti-predation rule alone is enough to prevent anti-competitive pricing *once entry has occurred*, but if the effects of competition can be got only by some *artificial encouragement to entry* then it is not enough. Instead some (otherwise pro-competitive) responses by dominant incumbents might have to be restrained.

The Dangers of Price Floors

Restraining the incumbent takes many forms. We find in the cases discussion of the alleged 'anti-competitive' nature of a great variety of businesses practice - non-cost-justified discounts (e.g. for

exclusivity or quantity), differential mark-ups, etc. But constraining the incumbent's price responses in order to facilitate entry into the market in effect means introducing a 'price floor' below which prices may not fall. The problem with price floor is that it creates a risk of *inefficient entry*, entry that occurs only because the most efficient (least cost) competitor is restricted from competing for the business.

Setting a floor in a way that does not encourage inefficient entry is informationally very demanding. It requires the type of information gathering and systematic industry monitoring that is associated more with a specialist sectoral regulator than with a generalist competition authority. Moreover, general competition law is not designed for the purpose of implementing sector-specific policies, for example where industries are in transition from monopoly to competitive markets. A competition authority, having a duty to enforce general legal prohibitions against anti-competitive actions, has little chance of reaching the correct regulatory decisions.

Five Ways to Get it Wrong

In analysing the effects of meeting competition there are five issues that arise again and again. We illustrate with a postal example but the points are general.

(1) Economies of scale

First, in newly liberalised industries, there is uncertainty as to the significance of the economies of scale. In postal services this issue arises in respect of daily doorstep delivery of mail. It may be that the incumbent will always have a large cost advantage over any entrant. The implication is that under genuinely competitive pricing a new entrant is likely to fail. It may well be inefficient for the courts to restrain the incumbent from reducing prices where he is still covering the relevant costs and making a profit, simply for the purpose of keeping a wasteful second network in operation. We want the market to *reveal* whether competition is sustainable or not in an industry.

(2) Economies of scope

Second, it is possible in many industries - certainly in post - that cost disadvantages due to scale could be offset by economies of *scope* (or joint production). For example a new entrant may be able to imaginatively combine different forms of delivery, or local delivery of different items, or to devise new 'products' which do not rely as much on high volumes. Competition authorities are not best placed to discern truly-alternative efficient entry from mere duplication.

(3) Universal service obligations

Third, postal and telecoms operators are still generally subject to a universal service obligation which imposes a constraint on both price and service quality. Traditionally they have been allowed to recover the loss-making elements of the obligation from the profitable parts of the service. A postal operator needs to be able to respond to entry in the profitable markets to allow it to retain at least *some* contribution to the fixed costs of the network. Again a generalist

competition tribunal faces a serious task in evaluating this need correctly.

(4) Cream skimming

Fourth and related to the foregoing, costs frequently vary significantly - e.g. in posts there is significant variation in delivery costs. This creates ample opportunities for cream-skimming entry in low-cost areas. Price differentiation between markets where entry occurs and does not occur is desirable because it steers investments by new entrants towards those markets where prices are higher. Constraining price responses in potentially competitive markets would blunt this information role of prices and induce wasteful investment.

(5) Discounts that are not cost-justified

Fifth, a principle sometimes adopted by courts to resolve the particular Article 86 case before them is to ask whether a particular discount is 'cost-justified'. Thus in the recent postal case price differentiation by region or by product was deemed anti-competitive unless 'cost-justified'. But there is no economic rationale for such a rule on *competition* grounds, i.e. on the basis that it is harmful to competition. Price discrimination can often enhance economic efficiency and businesses typically earn different returns on different products or activities. Indeed, firms constantly ask themselves what they are earning on different activities and wonder what they can do to bolster this activity or whether they should cut out that division. Joint and fixed costs have to be earned over multiple markets on activities that are subject to quite different competitive conditions. The 'cost justification' idea makes sense only if the underlying concern is to prevent predation - but we already have a rule against predation to take care of that.

Conclusions

The search by courts and competition authorities for a neat list of prohibited practices which are always anti-competitive and which cover all situations where consumers are harmed is a search for the impossible. Prohibiting normal business practices such as discounting creates a serious risk of inefficiency. In the newly liberalised industries, in those cases where a normal business practice can harm the development of competition, *regulatory* authorities might plausibly decide to restrict a company's ability to compete. However, before doing so they must face the key issues directly. They need to ask: Will prohibiting this practice in fact induce entry? Would such entry be efficient? Will the possibility of long-term consumer benefit outweigh the certainty of short-term higher prices? If these essential questions are asked then, in our view, regulatory intervention to assist entry will only rarely be justified.

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