ANTITRUST ECONOMICS 2013

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TOPIC 1: ECONOMICS OF COMPETITION POLICY

Overview

Part 1

- The importance of economics to the practice of antitrust
- How is the course going to help you learn antitrust economics
- Competition and why we care about it

Part 2

- The basic economics of competition policy
- The design of competition rule

Economics and Antitrust Practice

The importance of economics to the practice of antitrust

Antitrust based on and applies economic ideas

Antitrust involves the application of economic concepts such as markets, substitution, competition, market power, vertical restraints, and so forth.

- These are the subjects of a branch of economics known as industrial organization and of microeconomics more generally.

Most areas of the law, by contrast, involve the application of legal reasoning and principles to a set of facts.

- A court examining a breach of contract for the construction of a bridge applies contract law and not bridge engineering.

Economics *lingua franc* for antitrust globally

The case law and decisional practice have focused increasingly on economic questions.

Economic theory and empirical methods can help answer those questions and economists are often called on to do so by the agencies, the parties, and sometimes even the courts.

Globally, there is increasing faith in social benefits of markets. This has led to greater reliance on economics for understanding how markets work.

Why know antitrust economics?

- You will have to deal with economists at the main competition agencies: DG Comp, US DOJ, FTC, ACCC, CADE, MOFCOM, …
- You will have to hire and interact with economists for your case and counter those working for your adversaries.
- You will increasingly have to deal with economic arguments before the administrative and judicial courts.
- Economics plays a critical role in helping develop the theory of the case and assembling evidence to support this theory.

Economic ideas have wide influence

"Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

– Keynes, 1936

Economists: current and recent authority officials

Joshua Wright

FTC Commissioner

Joaquim Almunia

Commissioner currently in charge of competition policy

Mario Monti

Commissioner previously in charge of competition policy

Eduardo Perez Motta

President of Mexican Federal Competition Commission

John Fingleton

Former head of the UK Office of Fair Trading

Dongsoo Kim

Chairman Korean Fair Trade Commission

Elizabeth Farina

Former President of CADE, Brazil

Many authority heads and officials are Ph.D. economists and former economics professors

Most key authorities have a chief economist

Some examples from around the world

Howard Shelanski

Director, Bureau of Economics, FTC

Fiona Scott Morton

Deputy Assistant Attorney General, US Department of Justice

Kai-Uwe Kuhn

Chief Economist, European Commission

Thibaud Verge

Chief Economist French Competition Authority

Simon Roberts

Chief Economist, South Africa Competition Commission

Jarig van Sinderen

Chief Economist

Netherlands Competition Authority

Aleksey Sushkevich

Head of Analytical Department, Federal Antimonopoly Service, Russian Federation

The chief economist often has a significant influence on investigations and outcomes

Many economists at the agencies on cases

Examples from around the world

- US Federal Trade Commission: 70+ Ph.D. economists
- Antirust Division, US Department of Justice: 50+ Ph.Ds
- DG Comp, European Commission: 200 have background in economics, 20+ Ph.Ds in economics
- Bundeswettbewerbsbehörde, Austria: 7 economists
- CADE, Brazil: around 30 economists
- CFC, Mexico: operating staff around 50% economists
- Competition Bureau, Canada: 8 Ph.D. economists

Economics is used in enforcement guidelines

Examples from around the world

"…number of quantitative tests that have specifically been designed for the purpose of delineating markets. These tests consist of various econometric and statistical approaches: estimates of elasticities and cross-price elasticities for the demand of a product, tests based on similarity of price movements over time, the analysis of causality between price series and similarity of price levels and/or their convergence."

EC Commission's Market Definition guidelines

MOFCOM concluded that the transaction would … reduce the competitive pressures on HDD manufacturers in terms of pricing in bidding procedures organized by computer manufacturers. It also considered the increased risk of coordination between the remaining competitors …

MOFCOM Decision regarding the Seagate/Samsung merger

" If there are sufficient data to analyze the impact of a challenged business practice, the change in the level of prices and profits before and after the imposition of the practice can be used to assess the change in market power. It is important to control for the impact on market power of changes in relevant competitive factors, such as costs or the extent of competition from other firms, that are taking place at the same time.

Reference Document for the Determination of Substantial Market Power, Mexico

Economics is referred to in the decisions

Examples from around the world

Use of merger simulation and diversion ratios (within a one-level nested logit model) to clear the merger subject to conditions.

Unilever/Sara Lee Body Care EU, 2010

The Commission calculated diversion ratios and likely post-merger price increases to recommend to the Tribunal that the merged entity divest a brand to an independent player. The Tribunal concurred.

Unilever/Sara Lee South Africa

The CC used a Gross Upward Price Pressure Index (GUPPI) as a quantitative indicator to assess closeness of competition between the two companies.

Zipcar/Streetcar UK, CC 2010

The operation would lead Nestlé to increase prices in infant formula within a range of 2.9 and 11.5%, and a similar response by other competitors.

Nestlé/Pfizer merger Mexico, 2012

Economics is referred to by the courts

"Economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance, and the few recent studies on the subject also cast doubt on the conclusion that the practice meets the criteria for a per se rule."

Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007) U.S. Supreme Court

There is no evidence showing that the actual market competition was prevented or that such calculation of the annual demand volume was intentionally manipulated… Such profits are appropriate and there is nothing wrong with this in the context of the Anti-Monopoly Law.

Rokumi Sangyo v. Hinode Suido, et al., 2006. Intellectual Property High Court (IPHC), Japan

Economic ideas a core of most cases

Merger—what is the relevant market, competitive constraints, likely competitive effect of merger on prices, quality, and innovation.

Cartel—in the absence of a smoking gun do pricing patterns show evidence of collusion; by how much did prices increase because of cartel?

Abuse of Dominance—did actions foreclose significant competition and lack efficiency explanations?

Answering these economic questions often involves a combination of economic theory and empirical analysis, sometimes quite sophisticated, sometimes not.

Economics has become a powerful force

- Antitrust law has focused increasingly on economic questions
- Economic theory and empirical methods can help answer those questions
- Increasing faith (despite recent crisis) in power of markets to help society and therefore greater reliance on economic understanding of competition

Economic revolution in antitrust

Began to influence court decisions in the US in the late 1970s based on work largely begun in the 1950s.

Has expanded in the US and other jurisdictions ever since.

Now a consensus in the EU, US, and many other jurisdictions that the central focus of antitrust is the welfare of the consumer. Economics is key for analyzing consumer impact.

Some questions to discuss over lunch

Can you think of other areas of law in which the legal concepts are so intertwined with another discipline?

Competition laws question whether firms can merge but not whether they can grow very large organically. Does that make sense and why?

Executives are more likely to go to jail and for longer for insider trading than for participating in a cartel. Is that a sensible outcome and if not why has this happened?

Course Overview

How is the course going to help you learn antitrust economics

Give you tools and show you how to apply

First objective is to introduce you to the economic tools you need for examining antitrust

Second objective is to show you how to apply those tools to specific topics that arise in antitrust

Course to help you think like an economist

The course is designed to teach the fundamentals of economics and help you to start thinking like an economist.

It is not designed to give you a cookbook of a compendium of received wisdom.

It builds economics from the ground up so you can appreciate its strengths and weaknesses

Eight topics on antitrust economics tools

Module 1

1. Economics of competition policy
2. Firms and profit maximization
3. Demand, supply, and static competition
4. Innovation and dynamic competition
5. Product differentiation
6. Competition, market failures and welfare
7. Multi-sided platform economics
8. Game theory and oligopoly

Eight topics on applying antitrust tools

Module 2	
	9. Cartels and coordinated effects
	10. Competitive constraints and market power
	11. Market definition
	12. Horizontal mergers and competitive effects
	13. Predatory and other pricing strategies
	14. Vertical relationships and integration
	15. Vertical restraints
	16. Antitrust and intellectual property

Reading material and course preparation

Suggested textbook is Carlton and Perloff's *Modern Industrial Organization*

- Similar coverage is found in other industrial organization textbooks.
- Also useful to have a basic economics textbook such as Mankiw.

Most readings based on articles which are available online

- Those with * are required.
- Others you might peruse or use for deeper study or as reference.

Your CPI teaching team

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Course and IT support

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Where to find things and other details

Reading list and related material

https://www.competitionpolicyinternational.com/antitrust-economics-course-reading-list

Recording of lectures will be posted 4 days after each lecture

https://www.competitionpolicyinternational.com/antitrust-economics-course-lectures

Certification

CPI Certificate of Completion for Antitrust Economics

- Attend at least 24 live courses
- View all 32 lectures
- Yes, we know

CPI Mastery in Antitrust Economics Certificate

- Pass 2-hour multiple choice exam given 4 weeks after the end of Module 2

CPI Mastery with Honors in Antitrust Economics

- Passing grade on exam
- Honor grade on 3000 word essay

Static versus Dynamic Competition

The role of static and dynamic competition in antitrust analysis

"Competition" has two meanings, both important

Competition in the market:

The existence of multiple firms that seek consumer business and offer consumer choice. This is also called "static competition."

Competition for the market:

The act of striving against another force for the purpose of achieving dominance or attaining a reward or goal. This is also called "dynamic competition."

Static competition between firms

Each firm sets price to attract customers from other firms in the market that produce substitutable (interchangeable) products.

Product characteristics are set so firms cannot change the quality or characteristics of their products.

Firms' cost structures are set so they cannot expand capacity; cannot lower costs through improved technology or management.

Static competition mainly about price

Firms try to win market share by charging a low price.

Competition drives price down so that it just covers cost and offers a competitive return on capital.

More competition, lower price, greater output

When many firms vie for consumer demand they tend to compete price down to the lowest efficient level.

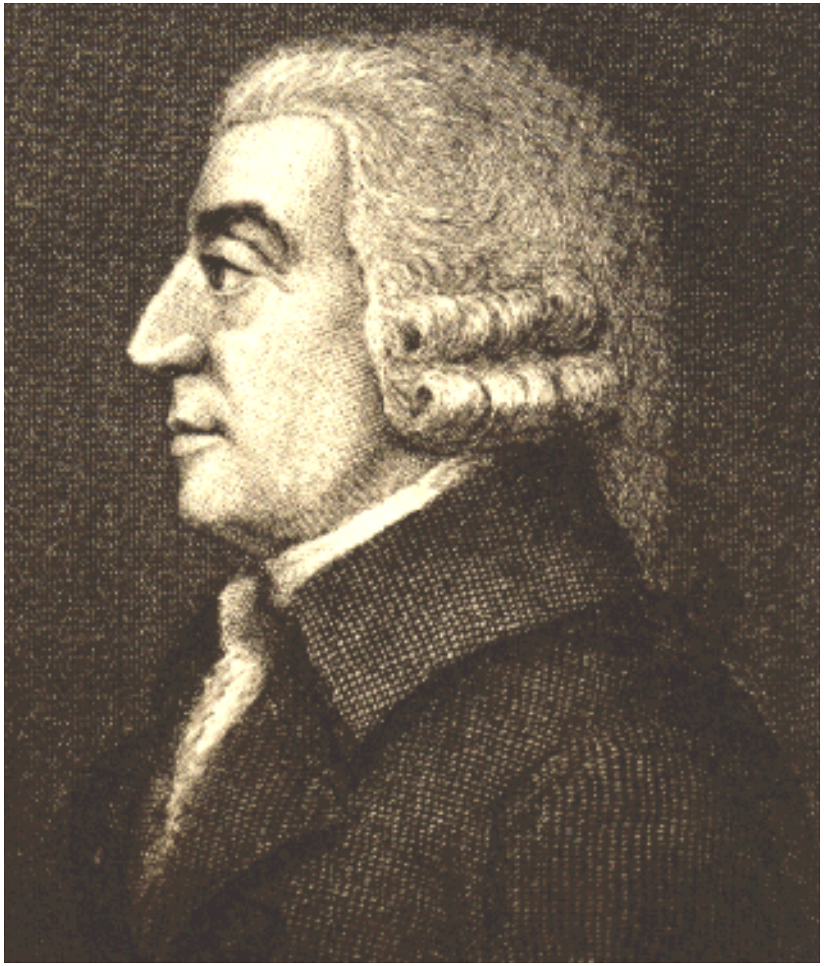
More consumers can afford to buy at lower prices so competition tends to increase output.

Depending on market circumstances society can get the benefits of competition with a few firms competing with each other.

Static competition and the invisible hand

- "Every individual...generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an ***invisible hand*** to promote an end which was no part of his intention."

– Adam Smith,
Wealth of Nations, 1776.



Dynamic competition for leadership

Firms race to secure leading position

- By being first to market with a product or service (iPhone)
- By finding a niche (left-handed guitars)
- By creating a brand (Lexus)
- By coming up with new idea for product or service or way for producing something more cheaply (search-based advertising)

Firms try to stave off rivals to recover their investments and risk taking

- First-mover advantages
- Intellectual property rights
- Switching costs
- Entry barriers such as economies of scale and network effects

Dynamic competition mainly about new features

Firms try to win category share by introducing new features through incremental innovation that differentiate them from rivals.

Firms engage in drastic innovation to create new products and dominate new categories.

Dynamic competition, innovation, efficiency

- More competition *for the market* leads to more innovation and greater efficiency in the long run
- The prospect of "monopoly" profits induces risky investment and innovation. Even though most efforts fail, firms race to come up with the next great idea.
- Society benefits enormously from new products and services that come from these efforts.
- Society also benefits when firms come up with innovations that enables them to produce things more cheaply.

Large rewards central to dynamic competition

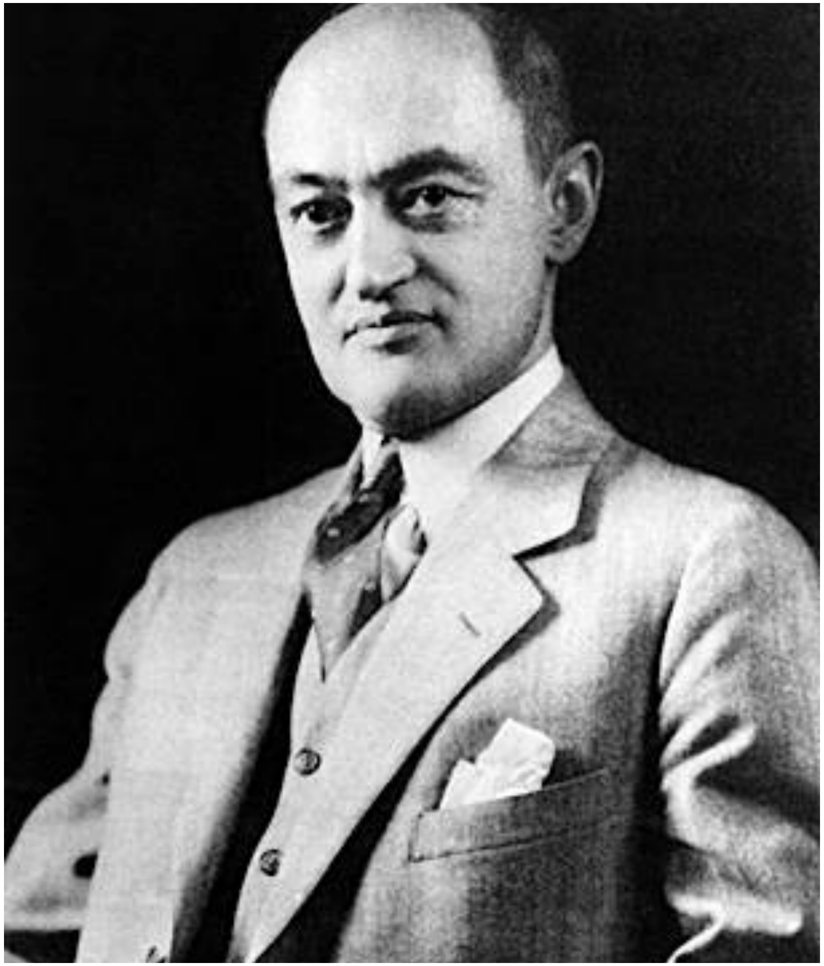
Like lotteries most entrepreneurs who play the dynamic game of competition lose.

There has to be a (large) prize for those who win to get entrepreneurs to play the game.

Dynamic competition and creative destruction

"the perennial gale of ***creative destruction*** strikes not at the margins of the profits of the existing firms but at their foundations and their very lives."

– Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, 1942.



End of part 1, next week part 2

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