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Resource pack for economics curriculum (secondary 4-6): anti-competitive behaviours and competition policy

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This resource pack is published to support schools’ implementation of the Economics Curriculum (Secondary 4 – 6) in September 2009. “Anti-Competitive Behaviours and Competition Policy” is a new topic introduced in the Curriculum. To provide teachers with references to the concepts, as well as local and overseas examples involved in this topic, the Curriculum Development Institute of the Education Bureau invited Prof Ping LIN and Ms Ching-yi FUNG of Lingnan University to develop this resource pack. We would like to express our special thanks to Prof LIN and Ms FUNG.

This resource pack was also uploaded to the website of the Education Bureau (http://www.edb.gov.hk) for teachers’ reference. If you have any comments and suggestions on this resource pack, please send them to:

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This Resource Pack is developed for an elective topic, ‘Anti-competitive Behaviours and Competition Policy’ covered in the Economics syllabus, in accordance with the Economics Curriculum and Assessment Guide (Secondary 4 – 6).

In developing the Resource Pack, we are mindful of the fact that the issue of competition analysis and related policy considerations is an integrated subject covering law and economics. It is a specialized subject unfamiliar to most school teachers. To meet the scope of the Economics curriculum at senior secondary level, the Resource Pack is developed with a focus on economic analysis and the behavioural aspects.

While there are jargons in any specialized subject, the concepts behind the jargons are explained in an easy-to-comprehend fashion in the Resource Pack with illustrative examples where necessary. Once the students have mastered the basic concepts and analysis covered in the curriculum, they are encouraged to explore for themselves the constantly changing social environment that impacts on the competition scenario.

This subject can be very lively, interesting and stimulating in terms of the teaching and learning experiences for teachers and students.

Ping Lin
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I. INTRODUCTION

Key concepts

Competitive market – a market with abundant supply of goods and services, where the natural forces of supply and demand regulate prices.

Anti-competitive behaviours – artificial means, by way of horizontal or vertical agreements to distort market competition, or by the abuse of market power to erect entry barriers.

Competition policy – rules and regulations to correct market distortion and to discipline anti-competitive behaviours.

Competition

A market is essentially a sphere of activities where suppliers of substitutable products compete for customers. Competition is derived from the rivalry between firms for the patronage of customers. The rivalry is driven by forces of supply and demand – the firms’ interests in maximizing their profits and the consumers’ interests in maximizing their welfare.

The ideal of a competitive market is conditional upon an abundant supply of goods and services by different suppliers, so that the natural forces of supply and demand can exert downward pressure on price. An equilibrium price is automatically generated in competitive markets by the entry and exit of firms responding to either excessively high or excessively low profits.

Competition produces three distinct economic benefits – production efficiency, allocative efficiency, and dynamic efficiency. Production efficiency is achieved if no resource is wasted in production. Allocative efficiency is achieved if the economic pie (or the sum of producer surplus and consumer surplus) is maximized given the available resources and technology. Alternatively put, allocative efficiency is achieved if no more unit of a good can be produced without giving up some units of a more valued good. By making firms compete, the market mechanism stimulates new techniques and innovation, thereby bringing about technological progress and dynamic efficiency over time.

However, the competition process may be distorted or restrained, and hence consumer welfare damaged, by players who engage in behaviours that reduce market competition.
Anti-competitive behaviours

Anti-competitive behaviours are those that distort competition, and can be classified into four main categories. ¹

(1) Horizontal agreements or collusion – competitors act together, through explicit or implicit agreement, to exploit customers by price-fixing, market allocation or bid rigging; or trade bodies take concerted action explicitly to restrain trade by joint boycott;
(2) Vertical restraints that lessen competition – buyers and sellers along the supply chain impose conditions of supply such as resale price maintenance, exclusive dealing, and exclusive territories, with the effects of reducing intra-brand competition;
(3) Abuse of dominance – dominant firms unilaterally impose onerous conditions of supply such as tying and bundling, predatory pricing, and price squeeze; and
(4) Anti-competitive mergers, horizontal, vertical or conglomerate – market participants merge together, not just to reap economies of scale, but also to increase market power, to raise prices, to foreclose entry, or even to exclude competition altogether.

Objectives of competition policy

Competition law serves to check and redress the market distortion caused by anti-competitive behaviours. A well-carved competition policy serves to ensure that firms compete effectively and the market functions smoothly, resulting in socially desirable outcomes.

The objectives of a competition policy are two-fold: (1) To assure firms a level playing field to conduct their business, without interfering with their prices and output decisions; and (2) to assure consumers the low prices and high quality that flow from effective competition.

For industry participants, it is essential to remove barriers to entry so as to ensure equality of access to market, including small and medium-sized enterprises (SMEs). For consumers, low prices and a wide range of goods and services will be fundamental to their needs. Competition is not a zero sum game. A competition policy, if properly implemented, will safeguard the interests of both the business sectors and consumers. The ultimate goal of a competition policy is “to promote economic efficiency or the best use of resources from the society’s perspective” (Economic Development and Labour Bureau, 2006).

Around 100 countries in the world have competition laws. The US is among the first to introduce a competition law (antitrust law as is called in the US) by enacting its Sherman Act in 1890. Japan promulgated its Anti-monopoly Law in 1947. Most developed economies have competition laws.

¹ Vertical restraints can be subsumed under abuse of dominance, reducing the classification to three categories.
Summary

A competitive market is one with abundant supply of goods and services, where suppliers of substitutable products compete for customers. The outcome of competition is economic efficiency. However, the market is never ideal. Suppliers may be motivated to seek monopoly profit by distorting competition. Anti-competitive behaviours take many different forms. The outcome is a reduction in social welfare. A competition policy is the mechanism through which the rules of the game are set to safeguard competition and correct market distortion. It is to ensure that consumers reap the benefits of competition and market participants conduct business on equal footing. The objectives are to benefit both consumers and market participants.

Discussion questions

1. What is the coverage of a general competition law? Discuss with reference to major anti-competitive behaviours.
2. Discuss why competition is beneficial to both the business sector and consumers, and society as a whole? In what sense does competition need to be safeguarded? Give examples to support your arguments.

Activities

1. Collect information (say from newspaper reports) on a certain industry in Hong Kong. Briefly describe the characteristics of the industry. Identify any unfair methods of competition that exist in the selected industry. Discuss with your classmates.
2. Give a real or hypothetical example where some sellers enjoy gains from anti-competitive behaviour. Now suppose a competition law is enacted so that such behaviour is no longer allowed. What are the effects of such a law on this group of sellers, on other existing or potential sellers in the market and on final consumers? Discuss your views in relation to the objectives of competition law and policy.

References

II. HORIZONTAL AGREEMENTS

Key concepts

Cartel – a concerted action among apparently independent firms who coordinate their activities by explicit or implicit agreement, typically to maximize their collective profits. A cartel can take the form of price-fixing, limiting output, bid rigging or other restrictive practices. It usually occurs in oligopolies involving homogeneous products, where the decision of a few firms can significantly impact the market as a whole.

Collusion – an act of cooperation or collaboration among competitors for their mutual benefit. Cartel is a form of collusion.

Price-fixing – a form of cartel among competitors who jointly set the selling price and restrict the output in order to maximize their collective profits.

Market allocation – a form of cartel among conspirators who allocate or apportion markets, products, customers or geographic territories among themselves.

Bid rigging – a form of cartel among competitive bidders whereby one party is designated to win the bid.

Joint boycott – a concerted refusal to deal, usually exercised by self-regulatory bodies such as co-operatives or associations.

Price-fixing

Definition

Price-fixing is a form of cartel where cartel members (or conspirators) take concerted action to avoid competing with each other. Price-fixing is a collusive agreement among a number of competitors that is designed to restrict output and achieve a higher profit for the cartel members.

A price-fixing agreement inevitably involves sales and production quotas among cartel members so as to achieve the aim of limiting production. Organization of the Petroleum Exporting Countries (OPEC), a well-known international oil cartel, has explicit rules of allocating production quotas among its member countries.

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2 OPEC is protected from lawsuits and criminal antitrust prosecution because the agreement to control oil prices is sanctioned by a multilateral treaty, which has been entered into by sovereign nations as opposed to individual firms.
Examples

It is observed from a research study (Kretschmer, 1998) that DeBeers has developed a unique purchasing and marketing cartel that regulates the quantity and price of diamonds in the market. The cartel has virtually been undisturbed for almost a century.

In the 1990s, there was a massive international cartel involving many different vitamins, among Hoffman-LaRoche, BASF, Rhone-Poulenc and other smaller producers. The cartel allocated market shares for each vitamin by country, specified price ranges, agreed on price increases, and shared information to avoid and detect deviation.

In January 2000, all the six mobile telephone services operators in Hong Kong engaged in a simultaneous price adjustment. The parallel conduct (indicative of an “arrangement”) was condemned by the Office of the Telecommunications Authority (OFTA) with the force of licence conditions. The event had occurred before competition provisions were written into the Telecommunications Ordinance.

Between April 2001 and June 2002, certain dynamic random access memory (DRAM) producers in the US and elsewhere entered into a conspiracy to raise and stabilize the price of DRAM chips. The Korean company Samsung pleaded guilty to conspiring with other companies, including Infineon and Hynix Semiconductor, in the price-fixing cartel. As of April 2007, the court has imposed criminal fines totalling more than US$730 million, which is the second highest fines ever imposed in a US criminal antitrust investigation, on the DRAM cartel members. A total of 18 individuals and four companies have been charged.

In April 2007, Dutch brewers were fined over €273 million for price-fixing (European Commission, 2007). The brewers coordinated prices both in the on-trade (consumption on the premises such as hotels, restaurants and cafés) and off-trade (consumption off the premises, mainly sold through supermarkets) segments of the market, including private label beer. Among the financial penalties imposed, €219 million was levied on Heineken.

In August 2007, a collusion over the price of long-haul passenger fuel surcharges landed British Airways with fines of £121.5 million and US$300 million imposed by the UK Office of Fair Trading (OFT) and the US Department of Justice (DoJ) respectively. Korean Air also pleaded guilty to the US prosecution and was similarly fined US$300 million. Lufthansa AG and Virgin Atlantic were conditionally accepted into the US Antitrust Division’s Corporate Leniency Program, and Virgin Atlantic also qualified in principle for full immunity under the OFT’s leniency policy and escaped financial penalty.

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4 OFTA, Case L/M T2/00 “Simultaneous Price Changes of Mobile Telephone Operators”.
Market allocation

**Definition**

Market allocation is an agreement between conspirators who allocate or apportion markets, products, customers or geographic territories among themselves. Without having to compete with each other, each will get an agreed share of the total market through allocation. The most common form of market allocation is geographic, whereby conspirators agree not to compete within each other’s geographic territories.

**Examples**

New Times and Village Voice Media were head-to-head competitors in publishing alternative news weeklies in Cleveland and Los Angeles. In October 2002, New Times agreed to shut down its New Times Los Angeles if Village Voice Media closed its Cleveland Free Times. They in effect swapped markets, leaving New Times with a monopoly in Cleveland and Village Voice Media in Los Angeles. In 2003, the DoJ required them to terminate their market allocation agreement. The remedies included divestitures of the assets of the New Times Los Angeles and the Cleveland Free Times to new entrants in those markets.

In January 2003, Bluefield Regional Medical Center (BRMC) and Princeton Community Hospital Association (PCH) entered into agreements to allocate cancer services to PCH and cardiac-surgery services to BRMC in six West Virginia counties and three Virginia counties. The DoJ annulled their agreements and prohibited them from entering into any agreement allocating any cancer or cardiac-surgery service, market, territory or customer.

Bid rigging

**Definition**

Bid rigging is an agreement between competitive bidders whereby one party is designated to win the bid.

In its simplest form, bidders privately agree in advance on each other’s bid prices, etc. It can take other forms. For example, if one member of the bidding ring is designated to win a particular contract, the other conspirators will avoid winning either by not bidding (“bid suppression”), or by submitting a high bid (“complementary bidding”).

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Bid rotation occurs when the bidders take turns to be the designated successful bidder. Simply put, each bidder is designated to win certain contracts, with conspirators designated to win other contracts.

**Examples**

In 1993, representatives of two dairies from Cincinnati in the US, Meyer Dairy and Coors Dairy, confessed to rigging bids in school milk auctions in the 1980s\(^\text{10}\). The bid-rigging scheme is one of respecting incumbencies. If one of the cartel members had served a particular school district in the previous year, then other conspirators were to refrain from bidding, or to submit high complementary bids that would not undercut the incumbent. During the bidding season, these competitors frequently communicated with each other to work out the details of the scheme.

From 2000 to 2002, thirteen roofing contractors were involved in a series of bid rigging activities, mainly collusive tendering for flat roofing and car park surfacing contracts in England and Scotland\(^\text{11}\). As of February 2006, the OFT had imposed on flat roofing contractors total fines of just over £4.3 million, and reduced the amount to around £2.5 million after leniency. Most of the rigged contracts concerned the installation of mastic asphalt for flat roofs or car parks. The customers affected included private developers and local authorities.

**Economic motivation behind collusion**

Monopoly profits are invariably higher than normal producer surplus derived from a competitive market. To seek monopoly profits, sellers are motivated to restrict competition by controlling outputs and fixing prices among themselves. When output is reduced, prices are driven up. Motivated by profit-maximizing incentive, sellers tend to collude than compete. When sellers collude to increase prices, loss of sales is minimized as customers lack alternative supply at lower prices. Colluding firms benefit at the cost of efficiency to society.

Despite severe penalties imposed on cartel members in some countries, conspirators still engage in collusive conduct because their expectation cost of being caught is discounted by the possibility of non-detection. They are therefore willing to run the risks.

In case of international cartels, the profit-maximizing motivation is even higher in countries that do not implement a competition law. The possibility of lawsuits is minimal, in view of the complicated jurisdictional issues for victims of an international cartel to sue in a foreign jurisdiction with competition law enforcement. Indeed, increasingly more cartels are international in operation.

Joint boycott

Definition

Joint boycott occurs when there is a concerted refusal to deal. Two questions must be answered to decide if a joint boycott is anti-competitive. First, whether there is a concerted action or conspiracy. If yes, the question turns on whether the refusal to deal unreasonably restrains competition.

Examples

Examples of joint boycott are usually found in co-operatives or associations which, as self-regulatory bodies, take collective action to regulate trade or discipline members.

*Fashion Originators’ Guild of America v FTC (FOGA)*

involved a joint boycott that intended to eliminate copying competitors from the fashion trade. Manufacturers of original dress designs sought to stop “style piracy” by refusing to sell to retailers who sold garments copied from the Guild members’ designs. Members who dealt with offending retailers would be fined. In restricting output and suppressing competition, the joint boycott was found to violate the US antitrust laws. The intent behind was to maintain the wholesale price levels of members’ dress designs.

In 1976, a group of Indiana dentists formed the *Indiana Federation of Dentists* to pursue a restraining policy not to comply with dental health insurers’ requests for x-rays, resisting insurers’ control on the costs of dental treatment. The restraining policy was found to violate the US antitrust laws, and the Federation failed to establish a pro-competitive justification for trade restraints.

Economic motivation

Co-operatives or trade associations often use joint boycott to regulate trade, to protect members’ interests and/or to discipline members for violating certain by-laws. Such joint boycott is largely a self-regulatory measure, and may not necessarily have an anti-competitive purpose.

But as a concerted refusal to deal, joint boycott can also be motivated by the desire to limit competition or fix prices (as in the case of FOGA). A violation of the competition law is found only if the concerted action unreasonably restrains competition, or with the intent to support a price-fixing cartel.

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12 *Fashion Originators’ Guild of America v FTC* 312 US 457 (1941).
Impacts on competition and society

The overall economic efficiency is reduced when firms engage in horizontal agreements. When prices are not driven by natural forces of supply and demand, but as a result of collusive conducts that reduce output to increase prices, the outcome is an overall reduction of social welfare. It is because some consumer surplus is translated into producer surplus while some is dissipated as deadweight loss. In other words, the gains to colluding firms are smaller than the losses to consumers, resulting in a net loss in social welfare and economic efficiency.

Public policy towards horizontal agreements

A competition law severely limits horizontal agreements, in view of their detrimental effects on economic efficiency. A cartel (price-fixing, market allocation or bid rigging) is usually prohibited per se, even if the cartel fails to achieve its purpose. A per se rule prohibits certain acts without regard to the effect of the acts. Most economists take the view that no enquiry as to the reasonableness of the cartel is necessary in conduct analysis, because it is well established in economic theory and practice that cartels do not give rise to economic efficiency.

In the case of joint boycott exercised by a self-regulatory body, the purpose behind may not be anti-competitive. The concerted action is therefore subject to a rule of reason, and will only be condemned if it is found to unreasonably restrain competition, or intend to support a price-fixing cartel.

The US antitrust laws have been used extensively to prosecute price-fixers, and penalties are coupled with criminal sanctions. The European Commission has refined its prosecution and enforcement against anti-competitive agreements, with increasing emphasis on economic analysis of the cases. Countries in Asia such as Japan and Singapore have also implemented their specific competition laws to combat anti-competitive conducts, especially horizontal agreements. Hong Kong is catching up in its introduction of a cross-sector competition law.

Summary

To seek monopoly profits, suppliers are motivated to restrict competition by colluding (or forming a cartel) to reduce outputs and increase prices. Profit maximization, at the cost of reducing economic efficiency to society, is the major motivation behind horizontal agreements among apparently independent competitors.
Cartels can be explicit or implicit, and mostly take the forms of price-fixing, market allocation and bid rigging. Joint boycott is often explicit, involving self-regulatory bodies having the intent to regulate trade or to discipline offending members.

Price-fixing is a cartel between competitors to control the output quantity and selling price of products and services among apparently independent competitors. Market allocation is a cartel between conspirators who allocate or apportion markets, products, customers or geographic territories among themselves. Bid rigging is a cartel between competitive bidders whereby one party is designated to win the bid. Joint boycott is a concerted refusal to deal, usually exercised by self-regulatory bodies such as co-operatives or associations.

**Discussion questions**

1. What are the main types of horizontal agreements among competing firms? Why do firms want to engage in horizontal agreements?
2. Do you agree that horizontal agreements among competitors should be outlawed as being unfair to consumers? Why or why not?
3. What is joint boycott? Why do trade bodies engage in joint boycott?
4. OPEC is an international oil cartel that operates outside the scope of any country’s competition law. What would happen to the world price of oil and the quantity of oil consumption if OPEC were made to operate under a standard competition law?

**Activities**

1. Conduct an Internet search to find two or three real life examples of price-fixing (local or overseas), and present them to your classmates.
2. Search, from the Internet or current news articles, and try to find one or two real life examples of bid rigging (local or overseas), and present them to your classmates.
3. Visit two supermarket chains. Note down the prices of different brands of sliced cheese (and two other lines of undifferentiated products). Pay two more visits at one-week intervals and repeat the same price taking for the same products and brands. Do you observe any parallel price movements? Discuss the possible underlying reasons.
4. Horizontal agreements among competitors are often secret and thus difficult to detect. What tricks can you possibly propose if you are to devise a scheme to detect and punish such conduct? [Hint: Read the reference article on beer cartel (European Commission, 2007). What are the carrot and stick that motivate cartel members to report cartel activities?]
References


III. VERTICAL RESTRAINTS

Key concepts

Free riding – an act of market participants who consume more than their fair share of a resource, or shoulder less than a fair share of the costs of its production. A manufacturer of no-frills products free rides on the investments and development costs of branded product manufacturers. A retailer can free ride on the promotional efforts of other retailers selling the same products in the vicinity.

Resale price maintenance – a practice whereby distributors are required to sell the manufacturer’s products at certain prices, above a price floor or below a price ceiling.

Exclusive dealing – an arrangement whereby a distributor purchases goods solely from a supplier and is prohibited from carrying competing brands, very often in return for sole distribution rights in a given area.

Exclusive territories – an arrangement whereby distributors are assigned exclusivity within a geographic area.

Resale price maintenance

Definition

Most manufacturers sell their products to the final consumer indirectly through a network of wholesalers and retailers. Resale price maintenance is a practice whereby distributors are required to sell the manufacturer’s products at certain prices, at or above a price floor (minimum resale price maintenance) or at or below a price ceiling (maximum resale price maintenance).

Examples

Resale price maintenance is widely used in automobile markets and in household appliance retailing. Book publishers often specify suggested retail prices to bookstores.

Economic motivation

Manufacturers and/or retailers can avail themselves of resale price maintenance to operate a cartel and charge a monopoly price. For example, in a price-fixing cartel in Germany for over a century, booksellers and publishers mutually agreed not to mark book prices below the publisher’s suggested retail prices for books sold in Germany, Austria and Switzerland (Baumgaertel, 1997).
Resale price maintenance can also be motivated by pro-competition considerations. In particular, resale price maintenance enables a manufacturer to induce its retailers to provide an appropriate level of services (e.g. product information or test drives in cars) in a sales transaction. Without resale price maintenance, some retailers may choose to offer drastically low prices and then free ride on the pre-sale services provided by other retailers of the same product. Resale price maintenance helps to eliminate such free riding by discount retailers on the pre-sale services efforts of full-price retailers, a possible outcome of excessively fierce price competition.

A possibly neutral motive for resale price maintenance concerns signalling. In certain cases, consumers may perceive a product (e.g. camera) sold at a very low price as having inferior quality. To prevent such a perception, a manufacturer may require its retailers not to sell its product below a pre-specified level.

**Impacts on competition and society**

As mentioned above, resale price maintenance can be used for both anti-competitive purpose (to facilitate price-fixing) and pro-competitive purpose (to eliminate free riding by retailers). Therefore, the net impacts of resale price maintenance on competition and society need to be judged on a case-by-case basis.

**Exclusive dealing**

**Definition**

Exclusive dealing occurs when a retailer or wholesaler purchases solely from a given supplier and is not allowed to carry brands from rival suppliers. Very often this is agreed on the condition that no other distributor will be appointed or receive the same supplies in a given area.

**Examples**

In car dealing, most car dealers around the world sell only the brands of the upstream car manufacturer, and are not allowed to sell rival brands.

In petrol retailing, each petrol station is tied to a petroleum supplier that the petrol retailer is prohibited from stocking or dealing in competing brands of petrol. Exclusive retailers are often of smaller scales of operation than non-exclusive retailers.
Economic motivation

A manufacturer is motivated to limit other manufacturers from free riding on its investments in sales outlets (advertising, promotion and retailer training etc). Under exclusive dealing, the exclusive retailer is offered better incentive and assistance from the manufacturer to provide both pre- and post-sales services. However, exclusive dealing can also be motivated by the anti-competitive purpose of creating a barrier to entry to restrict competition, as other manufacturers have to incur extra costs to set up their own distribution networks.

Impacts on competition and society

Exclusive dealing will benefit consumers in ensuring the exclusive retailers’ offer of pre- and post-sales services, while it limits free riding on the investments of one manufacturer by other manufacturers. It also assures quality and protects the reputation of the manufacturer. However, it can be anti-competitive by foreclosing third-party access to distribution networks or to inputs. It raises entry barriers by increasing distribution costs.

Exclusive territories

Definition

Exclusive territories take place when distributors are assigned exclusivity within a geographic area.

Examples

In certain direct sales, a team of salespersons representing the same brand is often assigned exclusive territories or exclusive counters (e.g. cosmetics and perfumes) to avoid intra-brand competition.

In car dealing, a car manufacturer invests in its own showrooms in certain territories, and enters into contracts of exclusive territories with its retailers.

Economic motivation

The allocation of exclusive territories can be motivated by the incentive to capture economies of scale in distribution, as it is easier to control the optimal number and density of retailers through allocation. It also serves to avoid destructive competition among the retailers or the company’s salespersons.
Impacts on competition and society

The allocation of exclusive territories promotes efficiency by capturing the economies of scale in distribution and providing incentives for retailers to increase sales and promotional efforts, which are necessary in expanding new markets. It addresses free riding of one retailer on the efforts of another. However, it may reduce intra-brand competition within territories and can thus be anti-competitive.

Public policy towards vertical restraints

There is a variety of reasons why a firm imposes vertical restraints on its distributors. Many, but not all of these reasons, promote competition. Vertical restraints, other than those on price, are analyzed by a rule of reason under the competition law. It requires assessing the effects of the challenged conduct. The positive pro-competitive effects of non-price vertical restraints will be recognized and weighed against the negative anti-competitive effects.

In general, the welfare effects of some vertical restraints are ambiguous, even after careful assessment. The analysis often relies on a foreclosure of competition doctrine. Where the vertical restraints significantly impede or foreclose entry by rivals or where they allow distributors or manufacturers to act like a cartel to raise the price level (say by fixing the retail prices), they would be prohibited.

Vertical restraints are generally considered to be less problematic than horizontal agreements, because their net welfare effects on society are not necessarily detrimental. Anti-competitive effects predominate only if one manufacturer has substantial market power and forecloses its distribution network to competition, or if all manufacturers in the relevant market impose similar (parallel networks of) vertical restraints.

Summary

The most common forms of vertical restraints are resale price maintenance, exclusive dealing and exclusive territories. The restraints are very often sanctioned by refusal to supply. Resale price maintenance is a practice whereby distributors are required to sell the manufacturer’s product within certain price ranges. Exclusive dealing is an arrangement whereby the distributor purchases goods solely from a supplier and is prohibited from carrying competing brands. Exclusive territories involve allocation of territories for distributors, each being assigned exclusivity within a geographic area.

Vertical restraints are generally considered to be less problematic than horizontal agreements, because they can often induce retailers to devote more sales efforts and hence stimulate demand and promote competition. However, vertical restraints can be used to support a price-fixing agreement. Therefore, vertical restraints are analyzed by a rule of reason under the competition law.
**Discussion questions**

1. What is resale price maintenance? Give examples of resale price maintenance that are not mentioned in this resource pack.
2. What is exclusive dealing? Give examples of exclusive dealing that are not mentioned in this resource pack.
3. Carry out the same exercise for exclusive territories.
5. In what ways can vertical restraints possibly lessen competition and harm society?

**Activities**

1. Identify a renowned international retail chain store in Hong Kong. Collect information on the mechanism of its business format. Discuss with your classmates in what aspects it may involve exclusive dealing, exclusive territories and/or resale price maintenance. Justify your views.
2. Imagine you are a computer supplier to a leading household appliance retailer in Hong Kong. Are you willing to provide training to its sales staff on, for example, the latest model of your company? What may be your considerations and concerns?
3. Imagine you have bought a new digital camera from a retail store in town at a bargain offer last week. Would you recommend your friends to buy it as well? Explain your views. Are there any psychological as well as practical reasons that influence your views?

**References**

IV. ABUSE OF DOMINANCE

Key concepts

Market power – a measure of economic strength: the ability to act unilaterally without significant competitive restraint, such as raising prices above competitive levels without fear of new entrants taking customers away.

Dominance – measured in terms of market power in competition analysis. The correct measure of dominance or market power involves defining the relevant market and measuring price elasticity and cross-elasticity of demand for the firm's products or services. But those variables are not easy to measure. As a short-hand measure for dominance, a firm's market share is commonly used as a proxy indicator.

Tying – a form of conditional supply whereby a supplier refuses to sell the tying product (usually a key product the customer requires) unless the customer also purchases the tied product.

Bundling – a commercial strategy whereby two or more products are offered together at a bundled price lower than the sum of the individual prices.

Predatory pricing – a strategy of a firm selling products below cost with the intent of driving competitors out of the market, or creating a barrier to foreclose potential entry, and then raising prices above competitive levels to recoup losses.

Price squeeze – a market power leveraging strategy undertaken by a vertically integrated firm, which prices downstream competitors out of normal profit, effectively foreclosing the downstream market.

Tying and bundling

Definition

Tying is a form of conditional supply whereby a supplier refuses to sell the tying product (usually a key product the customer requires) unless the customer also purchases the tied product. Bundling is an offer of two or more products together for a bundled price which is lower than the sum of the individual prices.

Examples

In the 1990s, Kodak\textsuperscript{14} sold photocopiers in competition with many other firms. It refused to supply certain parts to independent repair shops. As its customers were tied to its repair and maintenance services,

competition in Kodak secondary repair market was foreclosed to independent repair shops. However, for lack of market power in the initial sales market of photocopiers, Kodak may not gain competitive advantage in the secondary repair market by tying. Customers will buy less of Kodak photocopiers if they forecast a high repair cost. This comes down to the question of information deficiency. Secondary market lock-in may be possible if customers are less informed about the lifetime maintenance costs when making the initial purchase decision.

By way of proprietary design, printer manufacturers have in fact tied the sale of toner cartridges to laser printers. Consumables such as toner cartridges for one printer are not compatible with a printer of another brand, not even with another model of the same brand. Given that laser printers are often sold at very low margin and toner cartridges at high margin, this can have the effect of price discrimination, effectively charging the high intensity users more. Those with heavy printing requirements pay disproportionately more for the replacement cartridges (high-margin). They in effect subsidize other customers with low printing requirements as the printer (low-margin) already comes with a cartridge.

Computer software programs are often sold as a bundle, at a price substantially lower than the sum of their individual prices. For example, complementary software programs of word processing, spreadsheet and presentation are bundled together at a price close to that of an individual software program.

**Economic motivation**

Both tying and bundling can be motivated by efficiency benefits and anti-competitive effects. In terms of efficiency motivations, there are scale economies in joint supply and savings for customers in search costs, especially in the case of complementary products. For example, there are efficiency benefits to tie lens with the sale of camera, to bundle rechargeable battery with the sale of mobile handset. Another justifiable motivation is to assure quality, especially for high-tech products. For example, there is better quality assurance when a lift is serviced by its original manufacturer, and an automobile runs on its own proprietary tires.

In terms of anti-competitive motivations, tying can be strategically used to leverage market power, to foreclose entry to the tied market, or to price-discriminate customers. It is worth mentioning that tying and bundling can be practised by any firm, dominant or otherwise. But anti-competitive concerns arise only with firms in possession of market power in the tying product. If a firm is non-dominant, it has virtually no market power to leverage in the first place. For a firm not possessing market power in the tying product, strategies of foreclosure or price discrimination are usually ineffective, because entry barriers are mostly low and alternative supplies are available in a competitive market. In the Kodak example mentioned earlier, independent repair shops have other makes of photocopiers to service and informed customers will shop around for alternative brands.
When a firm has market power in one product but not the other, it will be motivated to leverage power between markets by way of tying. Leveraging is most successful when the firm has a tying product favoured by target customers. It can exploit its market power in the tying product to gain a competitive advantage in the tied product. For example, Microsoft has market power in its Windows operating system (the tying product), and it has tied its Internet Explorer browser (the tied product) to its Windows. Such tying harms the Netscape browser market, as users simply do not have extra incentive to download the Netscape browser, which is eventually given for free though. In the US\textsuperscript{15} the tying case against Microsoft ended with a settlement, and in the EU\textsuperscript{16} conduct remedies and a fine were imposed on Microsoft.

Bundling does not carry the threat of withholding supply on the key product, which can be bought separately. By strategically making a bundled offer at an attractive price, suppliers are able to increase sales and total revenues. Set meals are examples of bundling where a bundled price is lower than the prices of individual items added together. It may entice customers to consume more, such as adding potato chips to the basic items at an attractive bundled price. But the choice is still available to take food and drink à la carte.

**Impacts on competition and society**

Tying and bundling both have efficiency benefits and anti-competitive effects. They do not necessarily create greater inefficiency losses and can result in output expansion. Deadweight loss may even be reduced, and there is a transfer of consumer surplus to producer surplus and may give rise to a total welfare gain.

Tying and bundling are effective in increasing the producer surplus (or total revenue) only if there is practically no resale market for the separate products or if it is costly to locate buyers for resale. In case of perishable goods such as food and drink, it is not a good idea for customers to pay for extras and then try to resell.

Despite this, the anti-competitive impacts of tying warrant some attention, from the perspectives of market power leverage and price discrimination by a dominant firm. Bundling is usually viewed as a commercial strategy, given the choice available to customers of buying items separately instead of the whole bundle.

### Predatory pricing

**Definition**

Predatory pricing is the practice of a firm selling products below cost with the intent of driving competitors out of the market and then raising prices above competitive levels to recoup losses afterwards.

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\textsuperscript{15} United States v Microsoft Corp 253 F. 3d 34 (2001) (DC Cir (US)).

Examples

The EC Commission found that Wanadoo Interactive (WIN) had charged predatory prices for its Pack eXtense and Wanadoo ADSL services, with the intent of pre-empting the market for high-output Internet access services. On that basis, the EC Commission imposed on WIN a fine of €10.35 million.

Economic motivation

Predatory pricing is not beneficial to a business in the short run, as it may cause substantial losses when a price war is triggered. Yet a business is motivated to engage in predatory pricing if it pays dividends in the long run.

Competitors who are financially weaker than the predator cannot survive aggressive price competition. Predation continues until the weaker competitors are driven out of the market. The predator will then raise prices and recoup losses through monopoly pricing, assuming that re-entry by the weaker competitors is not feasible. In essence, the predator undergoes short-term pain for long-term gain. For the predator to succeed, it must have sufficient financial strength to endure the initial lean period.

Many economists do not regard predatory pricing as a credible strategy, which is unlikely to be employed by a rational firm because it suffers losses in the short run without any certainty of recouping the losses in the long term. Recent developments in economics show that such a strategy may be used to achieve a reputation effect whereby the firm deliberately establishes an image of “a tough competitor” and “always ready to fight”. Such a reputation may enable the predator to discourage new competitors from entering the market.

Impacts on competition and society

The effects of predatory pricing are controversial. Unfeasible predatory pricing benefits consumers in below-cost pricing (but may encourage inefficient product substitution) in the short run, and is self-deterring in the end. Consumers are harmed in the long term if predation is feasible (recoupment through monopoly pricing at a later stage).

True predation is difficult to distinguish from fierce but genuine price competition. Complaints are frequent (invariably from rivals) but successful prosecutions are rare. Allegations of predatory pricing require proof that the price is set below cost and the alleged predator has a reasonable likelihood of recouping its losses

17 CFI, Case T340/03 France Télécom SA (formerly Wanadoo Interactive SA) v EC Commission, 30.01.2007.
at a later stage. The recoupment test for predatory pricing is difficult to satisfy. It is extremely difficult to establish (or even speculate) that exclusionary low prices in the short run will be recouped later through monopoly pricing.

**Price squeeze**

**Definition**

A price squeeze is a market power leveraging strategy undertaken by a vertically integrated firm dominant in the upstream market. The dominant supplier prices the upstream input and the downstream product (or service) in such a way as to squeeze its downstream competitors out of normal profit, and ultimately force them to exit.

**Examples**

The EC Commission found that Deutsche Telekom (DT)\(^{18}\), the incumbent vertically integrated German telecommunications operator, had engaged in a price squeeze against its downstream rivals in the market for access to the local loop, which was a vital input to the provision of downstream products, narrowband (analogue and ISDN) and broadband (ADSL) services. DT charged its downstream rivals a higher fee for the access than the prices it charged its fixed line subscribers, the end-users, leaving no margins for competitors in the downstream market. The EC Commission imposed a €12.6 million fine on DT.

The Competition Appeal Tribunal (CAT) confirmed the OFT's finding against Genzyme of a price squeeze in supplying Cerezyme bundled services to home patients in the UK\(^{19}\). Genzyme was the sole supplier of Cerezyme, a very expensive drug with no substitutes for the treatment of Gaucher disease. Genzyme sold Cerezyme to the UK National Health Service at a bundled price which included homecare services. Having set up its own in-house provider Genzyme Homecare in May 2001, Genzyme sold Cerezyme drug at the full bundled price to Healthcare at Home (HH), leaving no downstream margins for HH or other homecare services providers in the provision of the bundled services to Gaucher patients. The CAT suggested the parties to find a negotiated price or other alternative solutions.

**Economic motivation**

The motivation behind a price squeeze is to price downstream competitors out of the market. The vertically integrated firm can compensate its downstream losses with its upstream profits, and does not suffer a loss overall.

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\(^{19}\) CAT, Case No. 1016/1/1/03 Genzyme v OFT, 11.03.2004.
Impacts on competition and society

The effect of price squeeze is a leverage of market power by a vertically integrated firm from its upstream to its downstream market, erecting its dominance position in both markets. The harm to the society is a foreclosure of the downstream market.

Public policy towards abuse of dominance

Dominance in competition analysis is measured in terms of market power. A firm possesses market power when it is able to act without significant competitive restraint. For example, it is able to charge prices above competitive levels without fear of new entrants undercutting its price or taking customers away.

Prohibition against abuse of dominance is designed to stop powerful firms from damaging the competitive process. However, over-vigorous prohibition against abuse of dominance, in addition to reducing market power, could dissuade powerful firms from expansion, or worse, unduly protect inefficient competitors. Striking the right balance remains a difficult policy issue.

Summary

Dominance, i.e. the possession of market power, is not condemned per se. Only the abuse of dominance to damage the competitive process is prohibited. The abuse of dominance can take many different forms. The most common are tying and bundling, predatory pricing and price squeeze. (Vertical restraints can also be viewed as a form of abuse of dominance.)

By way of product tying, a dominant firm can leverage its market power from a non-competitive market to a competitive market. The effect is to strengthen its market power further by locking in its customers, rendering them captive in both markets. Tying and bundling are also means of price discrimination. The effect is the transfer of some consumer surplus to producer surplus and an increase in total revenue.

Predatory pricing is selling below cost with the intent to drive out competition and foreclose entry. While low prices are often a welcome outcome of genuine competition, a drastically below-cost service could stifle competition by depriving competitors the chance to gain a foothold.

Price squeeze is a market power leveraging strategy undertaken by a vertically integrated firm, which prices downstream competitors out of normal profit, effectively foreclosing the downstream market. The price squeezer is able to recoup its downstream losses with its upstream profits.
Careful economic analysis is necessary to decide whether a dominant firm has abused its dominant position by weighing the social benefits of its acts against the detriments to competition.

**Discussion questions**

1. What are tying and bundling? Give examples that are not found in this resource pack.
2. What is predatory pricing? What is it aimed at? Why is such conduct difficult to establish?
3. What is price squeeze? What is it aimed at? How are the losses in the downstream market recouped?
4. Does the possession of market power necessarily lead to an abuse? Justify your views.

**Activities**

1. Collect some tariff plans from different services providers of bundled packages of broadband Internet access and pay TV. Discuss your observations with your classmates.
3. Name a few sectors in Hong Kong where dominant firms exist. Collect some background information on the firms which you consider dominant. In what markets do they have market power? Do they tend to or in fact abuse their market power? Illustrate your views with specific examples of their exclusionary acts.

**References**

V. MERGERS

Key concepts

Merger – a combination of two or more companies into one single company. Mergers are horizontal when occurring between competitors of the same industry; vertical when occurring between parties at different levels of the supply chain; conglomerate when occurring between parties of different industries or in unrelated businesses.

Economies of scale – benefit of efficiency; characteristic of a production process where an increase in the scale of the firm causes a decrease in the long-run average cost of each unit.

Potential competition – competition that is likely to arise when new competitors are able to enter the market, given the existing low entry barriers.

Merger control – a regime of regulating mergers and acquisitions under the competition law, subject to full market analysis, to prevent the acquisition of market power from the outset, so as to avoid the anti-competitive consequences of concentrations.

Horizontal mergers

Definition

A merger is a combination of two or more companies into one single company. Horizontal mergers take place when the merging parties are competitors operating in the same industry. Some mergers may even involve companies from different countries (cross-border mergers).

Examples

In June 2006, Cathay Pacific acquired Dragonair. It creates an aviation alliance between Cathay Pacific and Air China, by way of share restructuring between Cathay Pacific, Air China and Dragonair. Together, they are expected to become one of the world’s strongest airline groupings.

In 2007, the listed and partly privatized MTR Corporation merged with the government-owned Kowloon-Canton Railway Corporation. The merger represents a major step for rail expansion, including the Shatin to Central Link, the Express Rail Link and the Northern Link. The post-merger MTR Corporation operates a rail network covering Hong Kong, Kowloon, the New Territories and into the mainland.

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Economic motivation

Mergers and acquisitions are generally driven by the firms’ desire to realize economies of scale or scope, to increase the combined market share and to lessen competition; or by the acquiring managers’ desire for empire building. By merging with one another, the combined company can spread the overhead (fixed costs) among a larger scale of production, thereby lowering the unit cost of operation. After a merger, competition between the merging parties is eliminated, leading to raised prices and increased profits of the combined firm. Finally, a merger may be driven by the desire of the managers to be the leader of a larger company. (This motivation applies to vertical and conglomerate mergers as well.)

Cross-border mergers are increasingly common in recent years, as many sizable corporations are international in scope and operation. Cross-border mergers facilitate their diversification and international expansion.

Impacts on competition and society

Generally speaking, a horizontal merger has both positive and negative effects on society. While scale economies will enhance efficiency by lowering the cost of operations and minimizing the duplication of resources, lessening of competition may lead to reduced output and higher prices, resulting in a welfare loss to consumers. In an oligopoly, increased market share usually enables the merged firm to acquire significant market power, with the ability to act unilaterally in disregard of competitive restraints.

In theory as well as in practice, mergers can be a means by which the merged parties increase the combined market power or even monopolize a market. Furthermore, as horizontal mergers reduce the number of competitors, at least in the short run, they may increase the likelihood of collusive behaviour among competitors by facilitating coordination.

Vertical and conglomerate mergers

Definition

Vertical mergers take place when the merging parties are in a vertical relationship, such as wholesaler and retailer operating at different levels of the supply chain. Conglomerate mergers occur when the merging parties operate in different industries or unrelated businesses.
Examples

A merger between a potato chip producer and a potato farmer is a vertical merger, so is a combination between a computer chip manufacturer and a computer maker. On the other hand, an acquisition of a restaurant by a broadcasting company is a conglomerate merger.

Telia was the incumbent network owner providing termination call services in Sweden, Denmark, Norway and the Baltic States. Sonera was a downstream operator in such market. In Telia-Sonera22, the EC Commission analyzed the impact of the vertical merger on one of the relevant markets (the call termination market in Sweden and Finland). It cleared the merger by imposing upon Telia, among other undertakings, the commitment not to discriminate against downstream competitors on the access price or the quality of service at the wholesale level.

In 2001, General Electric (GE) proposed to merge with Honeywell International (Nalebuff, 2004). GE is a diversified industrial and financial company, with a substantial presence in aircraft engines, among others. Honeywell International is a diversified manufacturer, whose aerospace business occupies about half the market in avionics. Since there were few overlaps in the GE/Honeywell merger, the US DoJ considered it a conglomerate merger and approved it with minor changes. In the EU, the EC Commission viewed it differently and focused on “portfolio” or “bundling” effects. It was concerned that GE’s airplane financing and leasing business might further expand post-merger and act as a promoter of GE engines. The EC Commission proposed divestitures of parts of either the avionics or leasing businesses. GE responded by calling off the deal instead of agreeing to the concessions. The merger was then officially vetoed by the EC Commission.

Economic motivation

Two major motives for a vertical merger are the reduction of transaction costs, and assurance of supply of inputs. First, businesses between suppliers and customers often involve substantial transaction costs. Upon integration of the upstream and downstream operations, such businesses become internal to the merged company. It will improve the logistics along the different stages of the supply chain and reduce transaction costs. Second, through acquisition of an upstream supplier (e.g. a computer chip manufacturer), a firm (a computer maker) can ensure a guaranteed supply of the requisite inputs, thereby reducing the likelihood of supply shortage.

Conglomerate mergers are very often motivated by the desire for diversification. They also facilitate cross-selling among the different business units. For example, a bank acquiring a stock broker can promote its banking products to the stock broker’s clients, and the stock broker can approach the bank’s clients to sign up brokerage accounts, subject to compliance with safeguards against disclosure of personal data for marketing purposes.

**Impacts on competition and society**

It is recognized that most vertical or conglomerate mergers do not raise competitive concerns, because they do not involve combination of firms in direct competition. However, in certain circumstances, they can be anti-competitive if such transactions reduce potential competition.

To reduce the likelihood of entry by a new competitor, for example, a television set producer (upstream) may choose to acquire the only household appliance retailer in town (downstream). This has the effect of making it more costly for a new firm to enter the upstream market, as it may have to set up its own distribution outlet if it does enter.

Similarly, conglomerate mergers may also reduce potential competition. For example, a 3-G mobile phone company may originally intend to enter the cable TV services market through organic growth and diversification. A dominant cable TV service provider can prevent such potential entry by acquiring the 3-G company, hence reducing potential competition in the cable TV service market and maintaining its dominant position.

**Public policy towards mergers**

Most, if not all, economies in the world that have competition laws implement different regimes to regulate mergers. Singapore has incorporated merger control into its competition law regime, with effect from July 2007. Prohibition against anti-competitive mergers differs from other competition provisions because it addresses questions of market structure rather than questions of market conduct. It prevents the acquisition of market power from the outset.

Merger control is subject to full market analysis in order to allow socially beneficial mergers and prevent the socially detrimental ones. In a merger analysis, the test is whether the merger has the effect of substantially lessening competition in the relevant market. The regulator will also consider efficiency benefits favourably, so as to balance the efficiency enhancing effects of a merger against its potential adverse effects on competition. Most countries having merger control have set up explicit merger guidelines to provide specific information as to what types of mergers may be challenged by the government and how the government goes about evaluating a merger case.
Summary

Mergers and acquisitions involve a combination of two or more companies into one single entity. Mergers are horizontal when occurring between competitors of the same industry, vertical when occurring between parties at different levels of the supply chain, conglomerate when occurring between parties of different industries or in unrelated businesses.

Horizontal mergers can generate efficiency benefits such as scale economies. Vertical mergers can streamline logistics in the supply chain and reduce transaction costs. Conglomerate mergers can facilitate diversification. Indeed, mergers can be socially beneficial. However, mergers are prone to increase market concentration and can be driven by the motive of increasing market power. Merger control is a mechanism to prevent the acquisition of market power, so as to avoid the anti-competitive consequences of concentrations. Addressing questions of market structure, merger control is subject to full market analysis so as to allow socially beneficial mergers and block the detrimental ones.

Discussion questions

1. There are three types of mergers and acquisitions? What are they?
2. What are the main motives for each type of mergers?
3. In what ways can a horizontal merger benefit society? In what ways might it hurt society?
4. Repeat the above question for a vertical merger and a conglomerate merger respectively.
5. Almost every country that has competition law regulates mergers and acquisitions. What is the rationale behind that?

Activities

1. Collect some news articles about the merger between Cathay Pacific and Dragonair on Hong Kong-China routes. Make a list of the claims by the executives about the objectives of the merger. Identify any welfare benefits in terms of efficiency and competitiveness. Discuss, with supporting data if available, if the post-merger prices on some Hong Kong-China routes are in fact lowered.
2. Collect some news articles about the MTR and KCR rail merger. Discuss the prospect of seamless interchange arrangements for future railway extensions. Did the initial fare reductions meet your expectations? Explain. Debate the pros and cons of the fare adjustment mechanism.
3. Debate with your classmates the pros and cons of prohibiting horizontal mergers per se. Draw analogy with the case for cartel. Explore the possibility that two competing firms could avoid competition by forming a cartel or by merging with one another.
4. Take the supermarket industry in Hong Kong as a hypothetical case. A merger between the two near-duopolies would likely result in a monopoly, given the high barriers faced by new entrants (as demonstrated by the failures of Carrefour and adMart in the late 1990s). What would be the effects of such a merger on consumers and market competition? Discuss.
References

