CHAPTER 3: COMPETITION POLICY IN PRACTICE

3.0 How Is Competition Policy Enforced?

When consumers decide to purchase a product or service, for example petrol for their cars, the goal of a competition law is to ensure that their choices are not restricted unreasonably. OECD has published a comprehensive model law on competition where it describes the purpose of the law is '**to control or eliminate restrictive agreements or arrangements among enterprises, or merger and acquisitions, or abuse of dominant positions of market power, which limits access to markets or otherwise unduly restraint competition, adversely affecting domestic or international trade or economic development**[22]'. The model law on competition also emphasises that that we need to understand the concept of a 'relevant product or geographical markets', which is defined via the 'process of identification of a range of close substitutes for a product supplied by firms whose behaviour is under examination – or in the wording of the US Supreme Court, a market composed of products that have reasonable interchangeability for the purposes for which they are produced – price, use and qualities considered[23]'. Thus, a "relevant market" can be local, regional (as in the EU) or international in context.

The scope of a good competition framework should include enforcement policies that regulate the '**structure-conduct-performance**' dynamics of competition. A typical framework should include the following regulatory areas:

- Conduct policies – which are typically the most common antitrust area covering illegal business conduct that harm efficiency goals.

22 OECD, 'Model law on competition', Geneva 2000, page 11, http://www.oecd.com
23 OECD, Ibid, page 13

- Structural policies – which are typically focussed on activities like mergers and acquisitions that increases the level of concentration in a market, increasing barriers to entry and increasing the likelihood that the newly merged entity may be endowed with excessive market power.
- Performance policies – which are normally, focussed on monitoring price levels. For example, regulators may impose administrative pricing to reduce abusive pricing activities.

3.1 Conduct, Structural and Performance Policies

Conduct policies usually try to curtail anti-competitive business practices like restraints between competing suppliers in the same market (horizontal restraints) and restraints between non-competing parties in a buyer-seller relationship (vertical restraints). Antitrust law will try to protect competition by finding evidence that such conduct has harmed overall consumer welfare and efficiency goals. The complexity of enforcing such a law, however, arises when some of these illegal conduct enhances other objectives such as regional employment, export promotion, and social objectives. Because of this, enforcement authorities judge the legality of the restraint as either **'illegal per se'** or **'illegal by rule of reason'**. 'Generally, legality under **rule of reason** explicitly recognises that certain kinds of conduct may have efficiency-enhancing characteristics offsetting any harm to competition. In this circumstance, prosecution under the law proceeds on a case-by-case basis and requires proof that, in light of any mitigating circumstances, the overall effect of the conduct is to harm competition without sufficiently enhancing efficiency[24]'. In contrast, **per se** treatment only requires

24 Roger Alan Boner and Alan Krueger, 'The basics of antitrust policy, A review of ten nations and the European communities', World Bank Technical Paper No. 160, page 48

proof that the conduct has occurred - with little ambiguity. Some of the benefits of the per se approach is that it is inexpensive as not much enforcement resources are required to investigate the impact of the infringement unlike the rule of reason approach. The other benefit is that the per se approach seems stricter (because there is no room for arbitration) and is therefore perceived as being a better deterrent. The main disadvantage, however, is its inflexibility in negotiating allowance for when the conduct may actually is efficiency enhancing. Most of the time, antitrust statues are deemed per se only if there are certain agreements or conduct that blatantly harms competition and no redeeming value such as 'price fixing, horizontal division of markets and consumers, as well as horizontal concerted refusals to deal and bid-rigging[25]'.

The 2 main horizontal restraints that conduct policies deal with are price fixing and parallel pricing. In the case of price fixing, the laws of US, EEC, Germany, Korea, Japan, Australia, France and Canada uses a per se approach while Spain, Sweden and UK adopts a rule of reason approach. The reason why there is a difference is approaches is because some courts like the Restrictive Practices Courts in UK recognises that there may be some advantages to fix prices, like 'saving customer the cost of search for better prices products, lowering the market price by reducing the competitive risk faced by producers, and allowing the standardisation of products[26]'. Boner and Krueger argue that these pro-competitive effects do not exist because they believe that it is unlikely that the suppliers will try fix prices below the monopoly level, therefore, consumer savings will be very low. They also argue competitive risk reduction only protects the less efficient suppliers; therefore it decreases efficiency, not increase it. It is also false to assume that by allowing fixed pricing, the quality

25 OECD, Ibid, page 12

standards are raised because a competitive arena has proven to encourage suppliers to raise quality differentiation as well as increase the breath of the product lines. As such, it is recommended that other horizontal restraints like exclusionary practices, geographical allocation, and restraints on entry or output be evaluated under a per se standard as opposed to a rule of reason standard. Although Malaysia may choose adopt either approach, it must, however, declare of list of exceptions to price fixing for goods which are deemed essential like rice and petrol. In addition, another peculiarity in Malaysia is also seasonal price regulation, for example, the price of chicken during the festive reasons. The regulation for price fixing these items are controlled by the Ministry of Domestic Trade and Consumer Affairs via the **Price Control Act 1946**, which states that 'under this Act, the Controller has the power to control the price of goods, rationing of supplies and the price stabilisation – although, the provision of powers in relation to the price control and the rationing of suppliers is not enforced yet[27]'.

The treatment of vertical restraint in conduct policies is generally viewed on a rule of reason basis. Although suppliers and distributors/retailers may collude in setting prices, for example, via a resale price maintenance (RPM) agreement (which coerces the distributors/retailers into selling a specific price requested by the supplier), it has some efficiency enhancing virtues such as ensuring that the distributors or retailers provide a standard suite of service along with the sale of the product to ensure a quality sales delivery. Without such an agreement, unscrupulous distributors or retailers may short-change buyers and increase their profit margins unethically. In Malaysia, the **Price Control Order (Price Tag by Retailers) 1993** also requires that all retailers include

26 Roger Alan Boner and Alan Krueger, Ibid, page 52

price tags on all products or services so that consumers are allowed to make price comparisons to further regulate the conduct by retailers.

Structural policies complements conduct policies because it focuses on mergers, asset transfers, and takeovers; i.e. any affiliation that increases the market concentration and increases the likelihood that that the affiliated entity may exercise their increased market power. Structural policies complements conduct policies because a competitive market structure reduces the probability that a group of suppliers may get together to engage in some anti-competitive conduct. There are generally 2 tools used in structural policies, namely merger control and demonopolisation. 'Merger control inhibits concentration *ex ante* by selectively prohibiting mergers or equivalent contracts that would significantly raise concentration in the market. In contrast, demonopolisation inhibits concentration *ex post* by selectively breaking up concentrated enterprises in response to evidence of anticompetitive or abusive conduct or performance[28]'. **Most merger control regulation requires pre-merger notification** to the antitrust authorities for events like joint venture, asset takeovers, outright purchases of assets or companies and so forth. Generally, there is a waiting period for which the authorities will conduct some investigation on the probable impact of the suggested merger on consumer welfare (e.g. price of the good/service after the merger) and the level of concentration in the market. According to the survey done by Boner and Krueger, the criteria for pre-notification differs in many countries, for example:

- In UK, notification is required for asset transfers exceeding £39 million

27 Source: http://www.kpdnhq.gov.my/english/service/act_01.htm
28 Roger Alan Boner and Alan Krueger, Ibid, page 69

- In US, asset transfer exceeding USD100 million or 10 million of the acquired or acquiring parties (in either order), or if the size of the transaction is above USD15million, or if 50% of the voting rights are being traded.
- 'In Spain, France, UK, and Australia, a national sales share of 25% triggers registration requirement[29]'. The trouble with using this standard, however, is that calculating national market shares are generally very ambiguous and the relevant market may not necessarily be the size of the domestic demand.
- Japan requires pre-merger notification for ALL corporate asset transfers!
- In Malaysia, the **Malaysian Code on Takeovers and Mergers 1998 under the jurisdiction of the Securities Exchange Commission** (SEC) requires notification to the SEC of an intention to merge or take-over any other publicly listed company. The SEC does not, however, disallow this merger as long as anyone 'seeking to control more than 33% equity[30]' also extends this same offer to the rest of the shareholders in the company. The SEC is also not responsible for performing any industry concentration analysis to govern these transactions. Ironically, this code is subject to many non-transparent transactions, for example the leeway given by the SEC when it waived this mandatory offer requirement in 2001 when the government offered to buy up Tan Sri Tajuddin Ramli's Malaysian Airlines (MAS) shares at a price higher than the market rate without putting an offer to the rest of the shareholders.
- There is also another entity called the **Foreign Investment Committee (FIC)** that comes under the jurisdiction of the Economic Planning Unit of the Prime Minister's Department. This committee was set up in the 1974 to formulate policies and

29 Roger Alan Boner and Alan Krueger, Ibid, page 72
30 Source: Malaysian code take-overs and mergers 1998 at htttp://www.sc.com.my

enforce guidelines on foreign investment in Malaysia in line with the current objectives of the National Economic Policy. The committee is also responsible for the overall coordination and regulation of the acquisition of assets or any interests, mergers and takeovers of companies and businesses in Malaysia. Some of the key guidelines that require notification to the FIC are as follows:

- 'any proposed acquisition of 15% or more of the voting power by any one foreign interest or associated group, or by foreign interests in the aggregate of 30% or more of the voting power of a Malaysia company and business,
- Any merger or take-over of any company of business in Malaysia whether by Malaysian or foreign interest,
- Any other proposed acquisition of assets or interests exceeding in value of the sum of RM5 million, whether by Malaysian or foreign interest[31]'.

On the flip side of the coin, 'some countries with smaller markets believe that merger control is unnecessary because they do not want to impede restructuring of firms trying to obtain a "critical mass" which would enable them to be competitive in world markets. Others believe that having a "national champion" even abusing a monopoly position domestically might allow it to be competitive abroad in third markets. Two objections can be made to these views: First, it is often the case that monopolies enjoy their "monopoly rents" without becoming more competitive abroad, at the expense of domestic consumers and eventually of the development of the economy as a whole. Second, if the local market is open to competition from imports or FDI, the world

31 Extract from guidelines on acquisition of assets, mergers and take-overs of companies and businesses in Malaysia, www.epu.jpm.my

market might be relevant for the merger-control test, and the single domestic supplier might anyway be authorised to merge[32]'.

Merger control is a very expensive enforcement tool due to the expensive preliminary work required in investigating the proposed synergy. In US, the FTC and the DoJ use the **Herfindahl-Hirschman Index (HHI)**, a periodically published concentration index as one of the guideline in determining the impact of the merger on the level of concentration in the market.

If there are n firms in the industry, the HHI can be expressed as:

$$HHI = s_1^2 + s_2^2 + s_3^2 + \dots \dots + s_n^2$$

where s_i is the market share of the i^{th} firm. 'The Herfindahl-Hirschman Index is calculated by taking the sum of the squares of the market shares of every firm in the industry. For example, if there were only one firm in the industry, that firm would have 100% market share and the HHI would be equal to 10,000 -- the maximum possible value of the Herfindahl-Hirschman Index. On the other extreme, if there were a very large number of firms competing, each of which having nearly zero market share, then the HHI would be close to zero, indicating nearly perfect competition[33]'. If the HHI of a relevant market was 1000 is equivalent of 10 equal sized firms, then, HHI of 2000 is equivalent to 5 equal sized firms. 'An HHI of less than 1000 represents a relatively un-concentrated market, and the DOJ likely would not challenge a merger that would leave the industry with an HHI in that range. An HHI between 1000 and 1800 represents a moderately concentrated market, and the DOJ likely would closely evaluate the competitive impact of a merger that would result in an HHI in that range. Markets

32 OECD, Ibid, page 28
33 Source: Quick MBA-Economics-Industry Concentration at http://www.quickmba.com/econ/micro/indcon.shtml

having an HHI greater than 1800 are considered to be highly concentrated; there would be serious anti-trust concerns over a proposed transaction that would increase the HHI by more than 100 or 200 points in a highly concentrated market[34]'.

An alternative and simpler concentration index is called the **C_4 concentration ratio.** 'The concentration ratio is the percentage of market share owned by the largest m firms in an industry, where m is a specified number of firms, often 4, but sometimes a larger or smaller number. The concentration ratio often is expressed as CR_m, for example, CR_4. The concentration ratio can be expressed as:

$$CR_m = s_1 + s_2 + s_3 + \ldots\ldots + s_m$$

where s_i = market share of the i^{th} firm.

If the CR_4 were close to zero, this value would indicate an extremely competitive industry since the four largest firms would not have any significant market share[35]'. If the CR_4 is less 40, the industry is considered to be very competitive. On the other hand if CR_1 is about 90, the market is effectively a monopoly. Although it is useful, it provides an inaccurate view of the concentration levels because it does not use the market share of all the firms in the industry. It also does not provide information about the changes in the distribution of market share amongst the firms included in the ratio.

Proctor & Gamble's 1967 acquisition of Clorox as disallowed because Clorox had 49% market share in the bleach market and any the merger would have raise barriers to entry and market concentration significantly (source: FTC versus P&G 1967). Merger approval may be structured on a one-time basis or under periodical review based on

34 Source: Quick MBA-Economics-Industry Concentration, Ibid
35 Source: Quick MBA-Economics-Industry Concentration, Ibid

authorisation granted over a stipulated month or year that the merged entity meets certain terms and obligations. Merger control may also take into consideration other factors such as balance of payments, employment and regional development.

The 1997 Asian crisis led to a consolidation of the banking industry in Malaysia where the government (via Bank of Negara) had indicated that the number of banks should be reduced to 10 entities. There is no methodology published on how the magic number ten was stipulated and no competition framework to guide the ideal number of banks required. Perhaps, a tool similar to a HHI index may provide more tangible guidelines and better transparency to future industry consolidations. In the telecommunications industry, the Communications Multimedia and Communications Commission's (CMC) issuance of only three 3G licenses for the Malaysian telecommunications market sends indirect signals that some level of concentration analysis was done to persuade the telecommunications players to consolidate. It is not known whether CMC has done any preliminary analysis on what a reasonable national telecommunication budget should be for 3G services, the impact of the expenditure on the nation's balance of payment and so forth. There is no transparency or proof published by CMC to that any study was done.

As mentioned before, some mergers may still be allowed to proceed with certain conditions like divesture. '<u>Divesture is designed to negate the effect of a merger on concentration and maintain the competitive status quo by creating a new competitor from the merging parties</u>[36]', for example, MCI and Worldcom was allowed to merge if they divest the internet bandwidth access business units. It is important to note, however, that divesture is not suitable for all scenarios especially if the target divested product or market is heavily cross-subsidised by other products in the company.

Demonopolisation is another aspect of structural competition policies because it aims to lower the concentration of the market and invite new players to enter the market by lowering barriers to entry. The most significant demonopolisation event in Malaysia was deregulation of the telecommunications market, which saw 7 key mobile licenses issued to new players. In US, the largest demonopolisation case in history was the separation of the long distance from local service and the corresponding divesture of 22 Baby Bells (local telephone service providers) from AT&T.

Performance policies are generally used to prevent abuse of market power and monopolisation through "**administrative pricing**". Administrative pricing is centrally imposed on a supplier who is suspected of charging excessive prices. It is less popular because it is goes against the economic thought that the markets know better on what the proper level or price and output should be. Many cases have been brought to the EEC and Germany courts such as the Valium case, where the 'Cartel Office charged the Hoffman-La Roche pharmaceutical company with abusive pricing upon finding that Valium prices were 50% higher in Germany than in France and Italy and triple those in UK. The Cartel Office ordered price decreases for Valium to 60% of current levels. On subsequent appeal, the ordered price decreases were adjusted according to a complex formula account for competitive pricing in similar markets, supply advantages, brand name and research activities[37]'. As with most cases, it is difficult to impose

36 Roger Alan Boner and Alan Krueger, Ibid, page 81
37 Roger Alan Boner and Alan Krueger, Ibid, page 88

administrative pricing because often there is insufficient information to deduce abusive behaviour especially when suppliers do not compete solely on price.

3.2 The Legal Framework And Enforcement Capability

Like all laws, the effectiveness of antitrust laws will depend on effective enforcement in the areas of restrictive business practices, consumer protection and corporate law. OECD recommends that the enforcement of these laws are most efficient when it reside under the purview of a '**quasi-autonomous or independent body of the government with strong judicial and administrative powers for conducting investigations, applying sanctions**, etc., while at the same time providing for the possibility of recourse to a higher judicial body[38]'. According tot OECD's model law literature, some of the functions that should reside within this administrative authority are:

- To make inquiries and investigate infringements based on initiative or as part of a follow-up of a complaint submitted to the authority. (This includes setting up a facility to enable complaints of such a nature to be reported).
- To maintain a facility that receives pre-merger notification and performs the corresponding investigation that either recommends for or against the merger.
- To recommend decisions, sanctions, penalties to the judicial body and government ministry that it may report to. These sanctions or penalties may be in the form of a fine, prison terms, injunctions, divesture or compensation for injuries.
- To undertake studies and publish reporting which provide information to the public.
- To recommend new laws, regulation, policies to the judicial body and the ministries.

38 OECD, Ibid, page 33

It is recommended that there should be a legal facility to allow for appeals via the nation's judicial systems as well.

3.3 Overview Of Competition Framework In US, EEC and Korea

United States – Historically, 'antitrust laws were laws designed to combat monopolies ("trusts") and other devices to suppress competition. In the U.S., the individual states (as inheritors of the English common law and pioneers in the anti-monopoly efforts) did not help in dealing with such powerful combinations as Rockefeller's Standard Oil (which owned 90% of U.S. oil refining at the turn of the century). This led to the passage of the first federal antitrust law, the Sherman Antitrust Act of 1890[39]' and followed by the enactment of the Clayton Act and the Federal Trade Commission Act, in 1914. The **Sherman Act** declares illegal contracts and conspiracies in restraint of trade and prohibits monopolisation and attempts to monopolise. The **Clayton Act** later amended by the **Robinson-Patman Price Discrimination Act,** and the **Celler-Kefauver Anti-Merger Act**, deals with four business practices: price discrimination, exclusive dealing and tying arrangements, mergers, and interlocking directorates. The **Federal Trade Commission Act** contains only one substantive provision: "Unfair methods of competition in [interstate] commerce, and unfair or deceptive acts or practices in commerce, are hereby declared unlawful". US allow some cartelisation for export purposes under the **Web-Pomerene Act** (1918), however, this has not been widely used.

EEC – The competition laws within the European Economic Community is predominately concerned in ensuring that there is sufficient regulation to foster competition within the community. **Article 85** in the **Treaty of Rome** prohibits agreements amongst parties that may restrict trade while **Article 86** prohibits the abuse of a market position. The European Commission enforces the treaty in the national courts of the member states. The commission is allowed to rule on restrictive conduct as well as impose penalties and any appeals on such rulings can be brought up to the European Court of Justice.

Korea – The Korean model is an interesting model that the Malaysian Ministry of Domestic Trade and Consumer Affairs is potentially looking to emulate because its competition framework is structured to assist development goals. 'Korea is commonly and rightly regarded as an example of a developing nation whose growth has occurred through extensive economic management by the state, a policy strongly antithetical to the goals of antitrust. In particular, Korea has pursued economic growth through the concentration of economic and market power by, forcing companies to merge and by condoning price fixing by export trade associations[40]'. After the recession of 1970s, when Korea was more confident that its industries could compete effectively in the international area, it introduced its competition policy in the form of the **Monopoly Regulation and Fair Trade Act (MRA) 1980**. The enforcement of the MRA falls under the Fair Trade Office, which is a part of the Economic Planning Board. The Fair Trade Office conducts investigations, enforcement and policy development. There is also another separate entity called the Fair Trade Commission that performs advisory activities to the Minister of the Economic Planning Board and the Fair Trade Office on the interpretations of the MRA. The Minister is given some leeway in exempting certain restrictive practices 'where concentrations are necessary to rationalise an

39 Charles E. Mueller, 'Glossary of antitrust terms', American Law And Economics Review, Vol. 26. No. 4

industry or strengthen its international competitiveness[41]'. Any appeals are channelled via the Minister first before going to the Supreme Courts.

40 L. Jones and I. Sakong, 'Government, Business and Entrepreneurship in Economic Development', 1980
41 Roger Alan Boner and Alan Krueger, Ibid, page 44