Market Definition and Market Power

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Outline

- What is market power?
- What is the relevant market?
- How is the relevant market defined in practice?
- How do we measure market power in practice?

What is Market Power?

- Main objective of Competition Policy is provide conditions in which consumers can enjoy low prices, high quality and innovation.
- To do so, competition enforcement aims to prevent the creation or exploitation of **market power**.
- Informally, the term is loosely used in relation to firms with large market shares.
- In theory, market power is the ability of a firm to raise prices above its marginal cost.

What is market power?

- The **price-cost margin** is determined by the market share and elasticity of demand facing the firm:

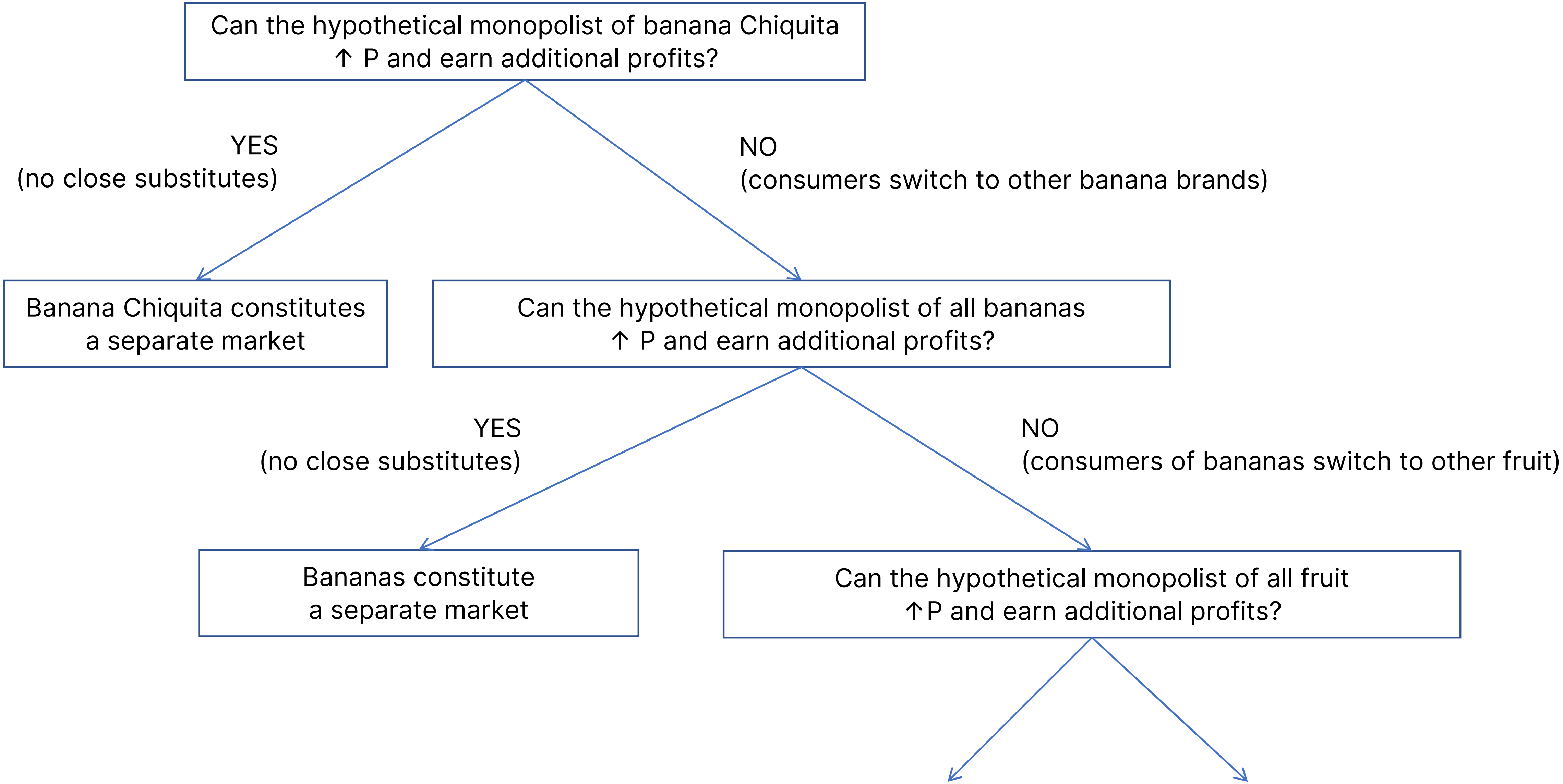
$$L_i = \frac{P_i - c_i}{P_i} = \frac{s_i}{\varepsilon}$$

- A firm may have a large market share but limited market power if the price elasticity of demand is very high.
- Highly elastic demand means that customers can easily switch away from the product in question to alternative products.
- Presence and closeness of competitors affects the range of alternatives available to the consumer.

What is the relevant market?

- The **relevant market** is a set of suppliers and products that exercise some competitive constraint on each other.
- We identify the relevant market using the hypothetical monopolist test – a thought experiment that asks whether a hypothetical monopolist of a particular group of goods would be able to profitably implement a small but significant non-transitory increase in price.
- If not, then the product must face an important competitive constraint from alternative goods.
- Such competition should be taken into account, i.e. the relevant market should be widened to encompass those constraints.

What is the relevant market?



What is the relevant market?

- Besides demand-side substitution, a candidate market may fail the hypothetical monopolist test because of <u>supply-side substitution</u>, i.e. entry of firms not currently active in the candidate market.

- In practice, we focus on <u>demand-side substitution</u>. How do we do it?

  - Own-price or cross-price elasticity of demand;

  - Price correlations tests;

  - Consumer surveys;

  - Etc.

How is the market defined in practice?

- In many cases, **qualitative evidence** is held to be sufficient:
  - Review of company documents and operating practices;
  - Review of product characteristics to predict whether consumers would be willing to switch.
- To be included in the relevant market, it is not enough for products to be functional substitutes; they need to be good enough substitutes to actually constrain each other's price.

How is the market defined in practice?

<u>Example 1</u> (adapted from Davis and Garces, 2010)

- Consider two different seafoods: smoked salmon and caviar.
- Caviar is potentially a functional substitute for smoked salmon in that it could be served as part of a salad. So should we include smoked salmon into a broader market that includes caviar?
- Suppose the retail price of 100g of smoked salmon is around €1.50–2.00 while the price of 100g of caviar runs into hundreds of euros.
- Salmon would be considered a market in itself despite it being a functional substitute for current customers of salmon.

How is the market defined in practice?

- Example 2: EC investigation of the proposed merger between Ryanair and Aer Lingus.

Airports	Distance to centre of city[107]	Private car[108]	Public transport[109]	Airport denomination on Ryanair website, Bus service to city promoted on Ryanair website[110]
Stansted	59 km	85 min	bus: 75 min rail: 45 min	London (Stansted) Ryanair bus service
Heathrow	28 km	65 min	*bus: 65 min*[111] rail: 55 min	Not served by Ryanair
Gatwick	46 km	85 min	*bus: 90 min*[112] rail: 60 min	London (Gatwick)
Luton	54 km	*44 min*	bus: 60 min rail: 25 min	London (Luton) Ryanair bus service
London City	14 km	*20 min*	rail: 22 min	Not served by Ryanair

Source: Case no. COMP/M.4439, p. 33.

How is the market defined in practice?

- Ryanair argued that the London airports were not demand substitutes for time-sensitive passengers.
- The Commission noted that the U.K. Civil Aviation Authority considers that a “2-hour surface access time” is the relevant benchmark for airport catchment areas for leisure passengers.
- The Commission concluded that scheduled point-to-point passenger air transport services between Dublin and above mentioned airports belong to the same market.

How is the market defined in practice?

- A survey also asked passengers at Dublin airport:

"Would you ever consider a flight to/from Belfast as an alternative to using Dublin airport?"

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes	445	16,6	16,6	16,6
	No	1751	65,5	65,5	82,1
	Don't Know	388	14,5	14,5	96,6
	No answer	90	3,4	3,4	100,0
	Total	2674	100,0	100,0	

Source: Case no. COMP/M.4439, page 367.

What is the relevant market?

- While we have used the hypothetical monopolist test to define the product market, the same reasoning applies when defining the **geographic market**.

- E.g. Consider a case involving the production of furniture in Malta.

Would a hypothetical monopoly seller of all Maltese furniture find it profitable to increase the price by 5-10%?

  - If yes, then the geographic market is defined as Malta.

  - If no because, say, imports from neighbouring Sicily would render such a price rise unprofitable, then the test should be repeated on a hypothetical monopolist of Maltese and Sicilian furniture.

How do we measure market power in practice?

- Once the relevant market has been defined, we may assess firms' market power using their **market share**.
- The Commission suggests that <u>dominance</u> is not likely if the undertaking's market share is below 40 % in the relevant market.
- If it were above 50% there might be the presumption that a firm is dominant, and the burden of proving that dominance does not exist falls on the defendant.
- But the market share is only one of the variables that we look at to determine market power.

How do we measure market power in practice?

- Ease and likelihood of entry by potential competitors might also constrain a firm’s ability to raise prices.

- We therefore consider the existence of switching costs, lock-in effects, network externalities, etc.

- Buyer power – which typically depends on the number of consumers in a given market – also determines market power.

- A large number of buyers will have coordination problems.

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