Profitability tests in competition law and ex ante regulation

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Abstract

This paper looks at one particular aspect of the application of concurrency—the analysis of profitability. It warns of the danger that the standards of assessment employed in utility price setting will be carried over from ex ante regulation to settings where it is inappropriate, such as the ex post analysis of competitive markets. Utility regulation profitability standards are inevitably static but if these are employed in a competitive setting the wrong signals and incentives will be set. The results will be inefficient levels of entry into existing partially developed markets and insufficient investment in risky developing markets. This may be more costly than failing to account properly for dynamics in ex ante regulation.

JEL classification: K21; K23; L40; L43; L51

Keywords: Competition policy; Regulated industry

1. Summary

The case made in this paper is that there are significant differences in approach between sector regulators and the competition authorities and that concurrency could lead to ideas from sector regulation being inappropriately applied in investigations under the Competition Act. The paper focuses on the treatment of profitability by competition authorities and sectoral regulators.

Profitability considerations do not appear to have been a determinant of outcomes in UK competition investigations, in contrast to the key role that the assessment of profitability has played in ex ante regulation. The ex ante regulatory framework and the competition law framework appear to apply different concepts of a competitive market benchmark and/or the extent of departure from the competitive benchmark that justifies intervention.

We suggest that the assessment of profitability should allow for dynamic effects. The static view of competition used by sectoral regulators is inappropriate and extending its use into competition investigations would lead to inefficient outcomes. A change in mindset will be needed when regulators undertake investigations under the Competition Act, as opposed to applying ex ante regulation.

Ex ante regulation should only be applied where there are likely to be net benefits relative to general competition law, taking account of both market and government/regulatory failures. The fact that the concepts of profitability applied under ex ante regulation are static also implies that there may be significant dynamic costs where ex ante regulation is applied, and that the appropriate boundary between the application of ex ante regulation and competition law should take this into account.

2. Differences in the treatment of profitability

2.1. Sector regulation

Sector regulators typically regard returns above the cost of capital as an indication that a company is charging excessive prices or has made an abnormal efficiency gain. They respond by tightening regulatory...
controls, albeit with a lag to maintain an incentive for cost reduction in the case of price cap regulation.

This view of returns earned can prevail even when the regulatory intention is simply to assess the need for ex ante regulation. Comments by Oftel in the context of the 2001 review of the mobile telephone sector provide an example of this:¹

In a competitive market, Oftel would expect prices, and consequently profits, to reflect efficiently incurred costs plus an adequate return on capital.

Profit levels which consistently and substantially lie above the cost of capital can be considered excessive.

Ex ante price controls have been driven by consideration of profit levels. This analysis is based on the proposition that regulation should mimic the workings of a perfectly competitive market, and that in such markets companies are expected to earn normal rates of return, i.e., just cover their cost of capital. However, the model of competition used is typically a simple static textbook model of equilibrium in a frictionless market with a large number of small firms. It is a simplistic and dangerous benchmark for determining the competitive price in a real market with long-lived assets, price dynamics, innovation, uncertainty and information asymmetries. All of these factors could lead to efficient competitive prices diverging from those predicted under the simple static model.

Empirical evidence suggests that the textbook, perfectly competitive, static model is a poor guide to how real competition works. There is an empirical literature testing the proposition that profit differences between firms persist even in the long run. It is found that, even in industries with high levels of entry, returns 15–20% above the cost of capital can persist and that firms with above or below normal profits at a given time can be expected to earn above or below normal profits into the indefinite future.²

2.2. Competition regulation

The regulatory approach is in stark contrast to the competition law model that has developed in the UK and is included in the Office of Fair Trading (OFT) guidance to the Competition Act, where the drive is to improve productivity and choice. Lower prices might ensue but they are not the main target.

The competition law approach acknowledges that there are many reasons why companies in competitive markets might earn significant returns and that such returns can serve as a signal for market entry where there is innovation and markets are dynamic. There is no expectation that firms will be found to be charging excessive prices merely because their returns are somewhat above the cost of capital. The OFT’s guidance makes this clear, stating that “it is unlikely, however, that the Director General would conclude that an undertaking was abusing a dominant position solely on the evidence of supra-normal profit.”³

However, the Competition Commission issued guidance on market investigation references in June 2003 suggesting an approach more akin to those of the sectoral regulators:

a situation where persistently, profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market could be an indication of limitations in the competitive process.⁴

Commenting on the use of profitability analysis in competition law, Sir Derek Morris, Chairman of the UK Competition Commission, noted in October 2003 that:

...profits typically will vary through time and across companies in a fully competitive market. There is no per se reason why profits in excess of the cost of capital represent anything other than the effective working of a competitive market. It is only where profitability is a) substantially above the cost of capital b) across most or all companies in a market over c) a sustained period of time, that concerns arise. But when this does apply then arguably it is a clear indication that competition is not working properly and is not fully effective. The main problems are, I suggest therefore, practical rather than conceptual.⁵

In the following section, we explain why the problems in assessing excess profitability are both conceptual and practical.

3. Do abnormal returns imply inadequate competition?

A static model of competition provides an inadequate counterfact against which to assess profitability.

¹ Oftel (2001).
³ 2.15 of OFT Guidelines “Assessment of Individual Agreements and Conduct”.
⁵ Morris (2003).
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