Competition and Monopoly in Markets

A **market structure** describes the characteristics of a market which can affect the behaviour of businesses and also affect the welfare of consumers. Some of the main aspects of market structure are listed below:

- The **number of firms** in the market
- The **market share** of the largest firms
- The nature of **production costs** in the short and long run e.g. the ability of businesses to exploit **economies of scale**
- The extent of **product differentiation** i.e. to what extent do the businesses try to make their products different from those of competing firms?
- The **price and cross price elasticity of demand** for different products
- The number and the **power of buyers** of the industry's main products
- The **turnover of customers** - this is a measure of the number of consumers who switch suppliers each year and it is affected by the strength of brand loyalty and the effects of marketing. For example, have you changed your bank account or your mobile phone service provider in the last year? What might stop you doing this?

The market for gas and electricity supplies – an oligopoly

The market for gas supply in the UK was **privatised** in 1986 with the market for electricity generation and distribution also transferred to the private sector of the economy a few years later. Since then there have been changes in the market share of the leading electricity distribution companies and domestic gas suppliers with the former state monopolies losing much of their dominance over this time. There are 26 million domestic electricity and 21.5 million domestic gas customers in Great Britain, supplied mainly by six suppliers.

Supplier	Market Shares in Electricity		Market Shares in Gas	
	December 2002	March 2007	December 2002	March 2007
British Gas	22	21	63	46
PowerGen	22	19	12	13
SSE	13	18	6	13
Npower	16	16	9	12
Scottish Power	10	12	5	9
EDF Energy	15	14	5	7
				Source: OFGEM

The UK energy market is split into three elements.

1. **Suppliers** –who sell electricity and gas to commercial, industrial and household consumers
2. **Distributors** - responsible for getting energy to users e.g. by building and maintaining the infrastructure of pipes and cables in the road and in installing meters.
3. **Generators** - responsible for generating the energy used in homes, offices and factories.

The retail market for energy is **competitive** because all customers are now able to change their gas or electricity supplier. In actual fact many people do not switch their suppliers even when they might be able to make savings on their bills. One reason is that people do not find it easy to get accurate **information** about what the differences are between these competing suppliers.

The gas and electricity supply industry is an **oligopoly** since the lion's share of the market is taken by the six leading businesses. But the market is *competitive* because consumers have a real *choice* about who will sell them their energy. The market share of new entrants into the industry since privatisation is now above 40 per cent for both gas and electricity.

The UK food retail sector is an oligopoly – shown by these market share figures for June 2008.

	Market Share (%)	Cumulative market share (%)
Tesco	31.2	31.2
Asda (Wal-Mart)	16.8	48.0
Sainsburys	15.9	63.9
Morrisons (Safeways)	11.4	75.3
Co-operative (Somerfield)	8.1	83.4
Waitrose	3.9	87.3
Aldi	2.9	90.2
Lidl	2.3	92.5

What is a monopoly?

1. **A pure monopolist** in an industry is a **single seller**. It is rare for a firm to have a pure monopoly – except when the industry is state-owned and has a legally protected monopoly.
2. **A working monopoly**: A working monopoly is any firm with greater than 25% of the industries' total sales. In practice, there are many markets where businesses enjoy some degree of monopoly power even if they do not have a twenty-five per cent market share.
3. An **oligopolistic industry** is characterised by the existence of a **few dominant firms**, each has market power and which seeks to protect and improves its position over time.
4. In a **duopoly**, the majority of sales are taken by **two dominant firms**. A good example of this is the market for razors in the UK – one dominated by Gillette and also is Schick (the

manufacturers of the Wilkinson Sword brand). Gillette has approximately 70% of the global shaving market.

How monopolies can develop

Monopoly power can come from the **successful organic (internal) growth** of a business or through **mergers and acquisitions** (also known as the **integration of firms**).

Horizontal Integration

This is where two firms join at the same stage of production in one industry. For example two car manufacturers may decide to merge, or a leading bank successfully takes-over another bank.

Vertical Integration

This is where a firm integrates with different stages of production e.g. by buying its suppliers or controlling the main retail outlets. A good example is the oil industry where many of the leading companies are explorers, producers and refiners of crude oil and have their own retail networks for the sale of petrol and diesel and other products.

- **Forward vertical integration** occurs when a business merges with another business further forward in the supply chain
- **Backward vertical integration** occurs when a firm merges with another business at a previous stage of the supply chain

The Internal Expansion of a Business

Firms can generate higher sales and increased market share and exploiting possible **economies of scale**. This is internal rather than external growth and therefore tends to be a slower means of expansion contrasted to mergers and acquisitions.

Barriers to Entry

Barriers to entry are the means by which potential competitors are blocked. Monopolies can then enjoy higher profits in the long run. There are several different types of entry barrier – these are summarised below:

- **Patents:** Patents are **legal property rights** to prevent the entry of rivals. They are generally valid for 17-20 years and give the owner an exclusive right to prevent others from using patented products, inventions, or processes. Owners can sell licences to other businesses to produce versions of their patented product.

- **Advertising and marketing:** Developing **consumer loyalty** by establishing branded products can make successful entry into the market by new firms much more expensive. Advertising can also cause an outward shift of the demand curve and make demand less sensitive to price

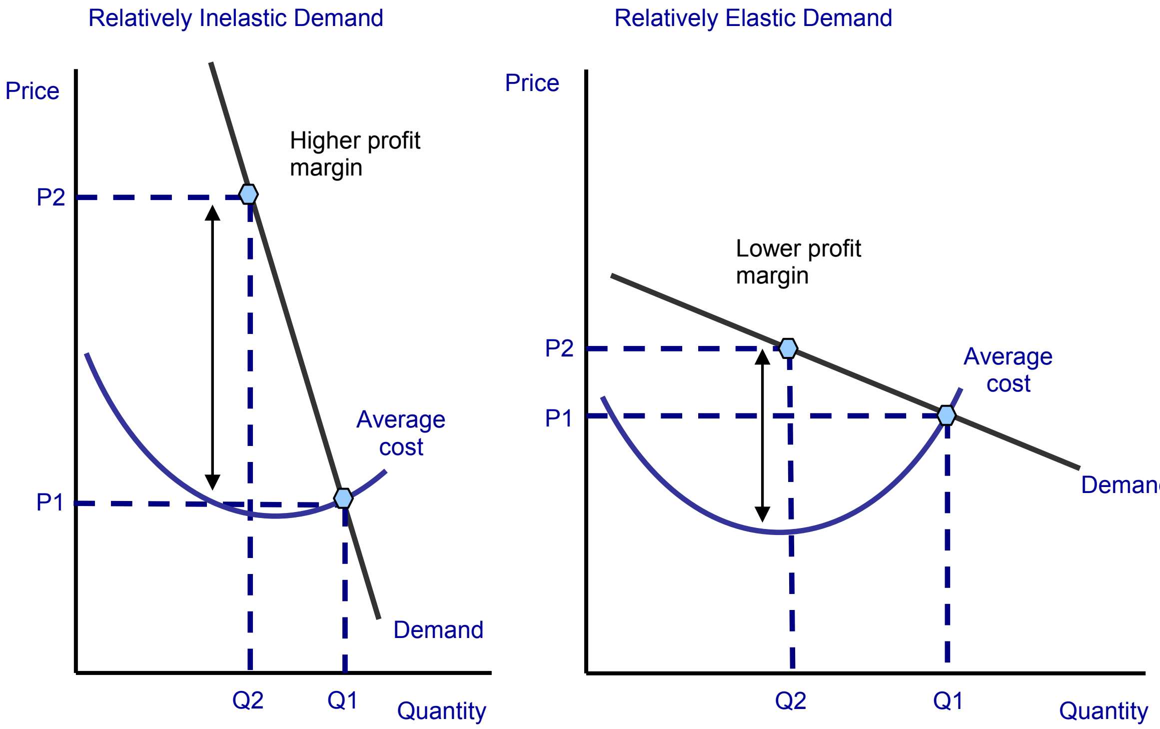
- **Brand proliferation:** In many industries **multi-product firms** engaging in brand proliferation can give a false appearance of competition. This is common in markets such as detergents, confectionery and household goods – it is **non-price competition**.

Monopoly, market failure and government intervention

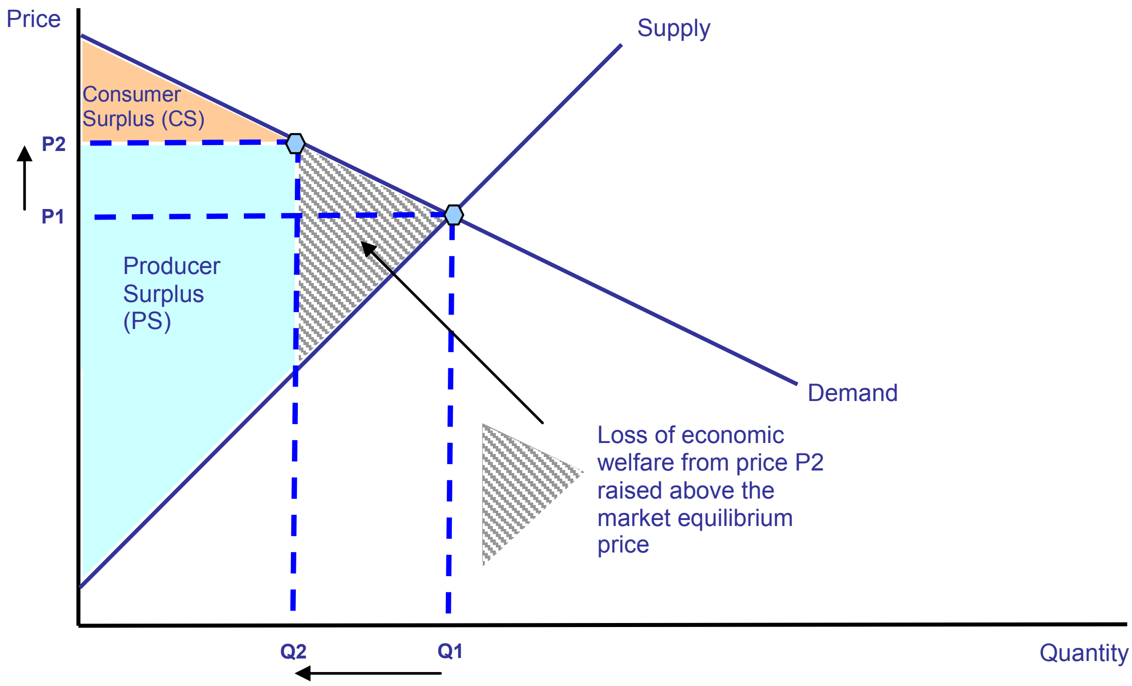
Should the government intervene to break up or control the monopoly power of firms in market?

The main case against a monopoly is that it can earn **higher profits at the expense of allocative efficiency**. The monopolist will seek to extract a price from consumers that is above the cost of resources used in making the product. And higher prices mean that consumers' needs and wants are not being satisfied, as the product is being under-consumed. Under conditions of monopoly, **consumer sovereignty** has been partially replaced by **producer sovereignty**.

Price



In the two diagrams above we contrast a market where demand is price inelastic (i.e. Ped <1) with one where demand is more sensitive to price changes (i.e. Ped>1). The former is associated with a monopoly where consumers have few close substitutes to choose from. When demand is inelastic, the level of **consumer surplus** is high, raising the possibility that the monopolist can reduce output and raise price above cost thereby operating with a **higher profit margin** (measured as the difference between price and average cost per unit).



If a monopoly reduces output from the equilibrium at Q1 to Q2 then it can sell this at a price P2. This results in a **transfer of consumer surplus into extra producer surplus**. But because price is now about the cost of supplying extra units, there is a **loss of allocative efficiency**. This is shown in the diagram by the shaded area which is not transferred to the producer, merely lost completely because output is lower than it would otherwise be in a competitive market.

Higher costs – loss of productive efficiency:

Another possible cost of monopoly power is that businesses may allow the lack of real competition to cause a **rise in costs** and a **loss of productive efficiency**. When competition is tough, businesses must keep firm control of their costs because otherwise, they risk losing market share. Some economists go further and say that monopolists may be even less efficient because, if they believe that they have a protected market, they may be less inclined to spend money on research and improved management. These inefficiencies can lead to a waste of scarce resources.

Potential Benefits of Monopoly

The possible economic benefits of monopoly power suggest that the government and the competition authorities should be careful about intervening directly in markets and try to break up a monopoly. Market power can bring advantages both to the firms themselves and also to consumers and these should be included in any evaluation of a particular market or industry.

1. **Research and development spending**: Huge corporations enjoying big profits are well placed to fund capital investment and research and development projects. The **positive spill-over effects** of research can be seen in more innovation. This is particularly the case in industries such as telecommunications and pharmaceuticals. This can lead to gains in dynamic efficiency and social benefits.
2. **Exploitation of economies of scale**: Because monopoly producers often supply on a large scale, they may achieve economies of scale – leading to a fall in average costs.
3. **Monopolies and international competitiveness**: The British economy needs multinational companies operating on a scale large enough to compete in global markets. A firm may enjoy domestic monopoly power, but still face competition in overseas markets.

SPEW

Here is a good way to remember some of the issues we have covered regarding monopoly, efficiency and economic welfare

Service - does the lack of competition affect the quality of service to consumers?

Prices - how high are prices compared to competitive / contestable market

Efficiency - productive, allocative and dynamic

Welfare - what are the overall welfare outcomes? Is there a net loss of welfare in markets dominated by businesses with monopoly power?

Acknowledged source: Ruth Tarrant

Case Study: The Cadbury-Kraft Takeover

In January 2010, Cadbury agreed to be taken over by its American rival, Kraft, in a £11.6 billion deal. A combined Kraft/Cadbury would rank alongside Mars, which in 2008 acquired Wrigley, as one of the world's biggest confectionery companies.

The new entity's CEO, Irene Rosenfeld, stressed that the combination was all about growth stating that the deal represented "a strong and complementary strategic fit, creating a global confectionery leader with a portfolio of more than 40 confectionery brands each with annual sales in excess of $100 million" with a leading position in developing markets such as Brazil, Russia, India, China and Mexico.

On paper, whilst it is clear why Kraft would want Cadbury's, it is unclear what Kraft brings to the party. The proposed deal brings together two very different organisations, with cultures and histories that appear to have more differences than similarities.

A lot of management time will now be taken up trying to integrate the Cadbury business into the Kraft empire (from selling 31 different types of cheese in 1914, it has grown rapidly via inorganic growth, most recently acquiring Danone for $7.2 billion in 2007, to become the largest American confectionary, food, and beverage corporation and the second in the world only to Nestle, marketing many brands in more than 155 countries). Comparing the two, in the last 12 months, Kraft's revenues reached $40.3 billion while Cadbury achieved $9.5 billion.

There is no doubting that size matters in the food business, where economies of scale can be significant in a number of ways. Particularly it can help a company gain monopsony power and negotiate with even bigger retailers and suppliers.

However, the fact remains that the majority of big M&A deals ultimately fail to create value for shareholders. Alleged over ambitious synergies never quite materialise and the disruption, and integration costs render many deals in negative territory.

Cadbury today is the product of a 1969 merger between Cadbury and Schweppes that was supposed to deliver superior synergies. But more than sixty acquisitions over the ensuing four decades created a sluggish conglomerate that ranked low on both profitability and competitiveness. Kraft could learn an important lesson from this, because in May 2008, Cadbury Schweppes split its business into two separate entities: one focusing on its main confectionery market; the other on its US drinks business stating that diversification did not guarantee a sustainable advantage. Arguably, it was this refocusing of operations that helped Cadbury's rise to the top; and perhaps the Kraft-Cadbury conglomerate again falls foul of this.

Source: Mo Tanweer, EconoMax, Easter 2010

Case Study: Local monopoly in action – the motorway service station network

Driving on the UK's motorways is rarely a pleasant experience as large sections of the network seem to be permanently congested. There is, at least, the opportunity to take a break at one of more than 100 service stations. The first service station was opened on the M1 in 1959 at Watford Gap. The number of service stations has almost doubled since 1990 from 55 to 102 but has that meant the much criticised standards have risen over the years? There have often been accusations of **high prices** and **poor quality of service**. Many feel that the service stations have a captive market and exploit this at the expense of consumers.

The UK's motorways are served for the most part by only three providers, Moto, Roadchef and Welcome Break – an **oligopoly**. These three names account for 85% of the market, the largest being Moto with 42 service stations and a turnover of £843m last year. Like many household names, although they operate as profit centres, they are part of much larger, often overseas owned, property companies. There are smaller operators such as First which owns two service stations, one on the M4 and another on the M61. The Tebay Services on the northbound M6 close to the Lake District are independently owned by Westmorland Ltd.

Is there evidence of real competition between the big three players in the market? Customer inertia may prevail. Many motorists see all service stations as much the same although there are online opportunities for motorists to find out the good and the bad from online user sites. Therefore they may be able to fill any information gap via the internet. The evidence is that service station operators engage in **non price competition** as seen by the 'tie-ups' that all now have with other retail and food outlets. Moto has on its sites Marks and Spencer's 'Simply Food' and Costa Coffee. Welcome Break has Waitrose and Starbucks while Roadchef has WH Smith and Costa Coffee. Indeed the service stations have become mini shopping malls.

New sites continue to emerge, taking advantage of the long forgotten gaps in the existing coverage of the 2,200 mile motorway network. In addition rising traffic levels mean a bigger customer base. The scope for new stations is limited by the government as they must be at least 15 miles apart which perhaps explains the decision by Welcome Break to start providing service stations on A roads.

There has also been a new entrant to the market, Extra MSA Services Ltd, which is part of the property group Swayfields Ltd. This group has McDonalds on its sites which include, Beaconsfield on the M40, Blackburn (M65) and Cullompton (M5). Their entry to the market indirectly resulted from the Competition Commission investigation into the merger of Granada and Welcome Break in 1995. Following that investigation the government deregulated the market making it easier for new firms to set up service stations. This attempt to increase contestability has had limited effect on increasing competition as Swayfields went into administration in March 2010. The new Cobham services on the M25 due to open in 2012 were being built by Extra but they may well have new owners soon. Will the incumbent firms in the market be allowed by the competition authorities to buy Extra as it will further increase market concentration?

Set against the criticism of motorway services we have to remember they provide free parking and free toilets. The **set-up costs** are high and the asset is specific to the service provided–arguably there are high sunk costs. In any case if motorists dislike service stations so much in the last resort they can bring their own sandwiches!

Source: Bob Nutter, EconoMax, June 2010

Government intervention in markets – an introduction to UK competition policy

Competition policy involves the **regulation of markets** to protect and improve consumer welfare:

- **The Competition Commission** – its main concern is to investigate mergers and takeovers to examine if these mergers will have a negative effect on competition. It also engages in in-depth investigations of markets where there are competition worries. A good example was the recent report into the UK supermarket industry.

- **The [Office of Fair Trading]** reports on allegations of anti-competitive practices including claims of **collusive "price-fixing" behaviour**.
- **The [European Competition Authority]** examines anti-competitive behaviour, mergers and takeovers between European businesses and investigates state aid to struggling businesses to make sure that subsidies do not reduce or distort competition.
- **Utility regulators** such as OFGEM, OFCOM and OFWAT monitor the industries that were privatised during the 1980s and 1990s. The regulators have used the power to introduce and review **price capping** and they have also have sought to bring **fresh competition** into markets. Competition was introduced into the telecommunications in 1984; in Gas from 1996-98 and in Electricity from 1998.

Many markets have firms with monopoly power but they seem to work perfectly well from the point of view of the consumer. Although there is a consensus among many economists that **competition** is a force for good in the long-run, we should be careful not simply to assume that monopoly power is bad and competition is good. There are persuasive arguments on both sides.

Competition Policy Snapshots

In the Frame

The European Commission has launched two competition inquiries to study whether IBM has abused its dominant position in mainframe computers. The study will examine whether IBM has put obstacles in place that prevent competitors from operating freely. The other inquiry, launched by the Commission itself, will look at IBM's relations with maintenance suppliers. (August 2010)

Bathroom cartel

Seventeen bathroom equipment makers have been fined a total of 622m Euros by the European Commission for price-fixing. Given the relatively homogenous nature of the products offering in this industry, and the high concentration ratio, it is ripe for collusion and cartel-like behaviour. (June 2010)

Capping mobile charges

The Telecoms regulator OFCOM has ordered UK mobile phone companies to cut the cost of termination charges - levied when people phone different networks from 4.5p to 0.5p by 2015. Mobile termination rates are the wholesale charges that operators make to connect calls to each others' networks. (April 2010)

Heavy fines for tobacco cartel

The Office of Fair Trading (OFT) has given out the largest ever total fine in a case under the UK Competition Act 1998. A huge fine has been imposed on two tobacco manufacturers and ten retailers engaged in illegal price fixing for tobacco products in the UK. This is a good example of the financial risks that companies face when found guilty of anti-competitive behaviour. The tobacco manufacturers involved are Imperial Tobacco and Gallaher, and the retailers are Asda, The Co-operative Group, First Quench, Morrisons, One Stop Stores (formerly T&S Stores), Safeway, Sainsbury's, Shell, Somerfield and TM Retail.

Imperial Tobacco was fined £112m and Co-op and Asda were penalized by £14m each (April 2010)

Source: Tutor2u Economics Blog