CCR - Competition Competence Report Autumn 2016/3

The conflicting application of the Chicago School and the European School in merger proceedings

The two previous autumn 2016 editions of the CCR discussed how EU competition law contributes to the proper functioning of social market economies in Europe.

The buzzwords in this respect are 'equality' and 'fairness' which characterise what the social side of competition law Europe is standing for.[1]

In contrast to this, other schools of thought - like the US Chicago School - apply a laissez-faire ideology to competition problems. In this school of thought, consumers are considered to be rational economic human beings and the protection of a vital competition process is of less concern since the markets will manage themselves anyway.

Europe on the other hand is rooted in a pro-regulatory philosophy: The Lisbon Treaty contains a pre-defined economic order that is supposed to be implemented by independent authorities and courts.[2]

The most striking disparity between the two systems is the distribution of wealth gains. Whereas the creation of wealth as such is a top priority in both schools, a fair and equal re-distribution of wealth is only a concern in Europe.

Europe achieves this social market economy objective by operating an appropriate competition law regime. In this sense, the European approach is much more embedded in real life situations today, which display a variety of facets attached to the well-being of people.

In this CCR, the focus is on how the European School and the Chicago School would approach the same hypothetical merger situation. It will be seen that the different principles inherent in the schools of thought will lead to the outcomes of the case concluding differently.

The CCR concludes with a table summarising the differences that the European approach and the Chicago School approach deliberate.

---

[1] See also STATE OF THE UNION 2016 speech by Jean-Claude Juncker, President of the European Commission, 14 September 2016, p. 11.

[2] In contrast to a free market economy the state is not passive. It actively implements regulatory measures, in particular, with respect to protecting free market forces.

Pizza or Pasta: A Hypothetical Merger Case

In a small town, there are three restaurants offering Italian food with each restaurant having a market share of about 33%.

The town has other restaurants too offering Greek, Indian and Chinese food. A few additional permits to open new or appropriate facilities are available as well. The town itself is primarily home to normal families (2 adults, 2 children) with medium incomes. The relevant geographic market is the town.

One Italian restaurant specialises in pastas, the other one in pizzas whereas the third one offers the full range of Italian food including pastas and pizzas. The two specialist restaurants are well-known for their quality of products whereas the third full-range restaurant just offers a medium quality.

Prices in all the three restaurants are comparable at a medium price level.

All three restaurants have a simple furniture style including red and white checked paper tablecloths, one type of house wine etc.

To attract more customers, the Italian restaurants offer special midweek fixed price 'all you can eat' packages and 'kids up to 7 years eat free' on weekends.

Pre-merger, a family with different tastes needed to decide either to go to the pizzeria (for the benefit of the family members who prefer pizzas and to the detriment to the others who prefer pastas) or to the trattoria (again for the benefit of the other family members preferring pastas and to the detriment of those who prefer pizza). The third option available for families was to go to the lower quality full range Italian restaurant. There, all family members can eat, depending on their individual preferences, either pastas or pizzas.

The Transaction: 3-to-2 merger

The two Italian restaurants, the one specialising on pizzas and the other one on pastas, merge. The new entity offers a full range of Italian meals post-merger at a high-quality level. A price increase post-merger is likely.

Post-merger it is likely that families will prefer the new entity since it combines both pizzas and pastas at a higher quality than the original full range restaurant.

The prognosis is that the original full range restaurant is put under pressure post-merger since it has to compete with another full-range restaurant with high quality products. It is likely that the quality of the food and the service in this original full range restaurant will improve as well. This restaurant will probably hire a new chef and use better quality ingredients, which in turn will increase its costs and prices.

The new merged restaurant has already moved to the larger unit of the two restaurants and has closed down the smaller site. The number of seats in the new restaurant has increased and the opening hours have been lengthened but it is likely that the seating capacity will soon be achieved. The merged restaurant will stop offering special deals for families in order to manage its seating capacities better.

The popularity of this new restaurant will attract visitors from outside the town. Thus, the relevant geographic market is enlarged post-merger since more people will want to dine in the new merged restaurant. However, as demand for seats in the restaurant increases, the new entity post-merger will likely increase prices even further.

To increase its profits, the new entity will also start offering better and enhanced services such as linen tablecloths and cloth napkins and will add a broader assortment of Italian starters and desserts as well as an extended wine list, candles on the tables and live music on occasions.

Post-merger the prices as well the quality in these two restaurants are higher.

The question now is how the European School and the Chicago School will assess the competitive effects of such a hypothetical merger and what the outcomes will be?

The Chicago School Approach

The 3-to-2 transaction is cleared with no remedies.

Post-merger families have an additional 'one stop facility' for Italian cuisine out-of-home consumption at an excellent quality/service level despite a combined market share of 66%. All family members are served by one location with their favourite meals at a high quality. There are no discussions anymore within families as to which Italian restaurant to go to.

The new entity is able to produce significant efficiencies by combining the two restaurants into one outlet. Post-merger just one kitchen is required thereby downsizing fixed costs considerably (with just one head chef). Costs for service personal are reduced as well because of the overall reduction in seating numbers. Where the restaurant needs to modernise its furniture, costs are also considerably lower. Variable costs for electricity, heating/cooling, etc. will also go down. On the other hand, the buyer power of the new restaurant is going to increase enabling the owners to get a better bargain. Transaction costs for shopping supplies are lower too.

Despite these cost reductions, post-merger prices are increased which in turn leads to an increase in profits, and thus a producer surplus.

Post-merger the duopoly of the two Italian restaurants in the village will lead to market entry in the long run by other restaurants. New restaurants will be attracted by the high profits that can be earned in this small town.

The town even starts becoming known regionally as the 'place to be' for excellent Italian food enlarging the geographical market further. There is even the chance that the new restaurant will be awarded with a Michelin star post-merger. This excellence criterion in turn will be paid for by the additional visitors attracted by this award. The expectation is that the quality of the Italian food will increase further post-Michelin star.

Based on Chicago School thinking, we see a clear increase in producer welfare thereby increasing total welfare. The issue that families pay much more post-merger does not matter since clients are awarded with an excellent top-ranked full range Italian restaurant in their small home town. Competition between the two full-range high quality restaurants is likely to increase and market entry by potential competitors is likely as well.

The European School Approach

The 3-to-2 transaction is cleared with remedies.

Post-merger, the two Italian restaurants remain with a similar product portfolio - pizzas and pasta - although at different service levels: the new entity with a market share of 67% offers a high quality whereas the established one with a market share of 33% has a medium service level only. The question is whether the transaction creates consumer benefits and whether these benefits are re-distributed between market participants in an equal and fair manner.

The European School appreciates efficiency gains that accrue directly in a profit increase for the owners. However, this element is not the decisive one.

In a European style assessment, it is important to consider how the existing customers, in our case the middle-class families (2 adults, 2 children) in town, receive the economic effects of the transaction. The European School in particular cares about this average consumer/customer. Thus, the question to be answered is whether the wealth gains - increase in owners' profits - are fairly distributed between the customers and the owners. Another issue is whether the effects also relate to the consumer 'wants' too.

In a European-style competitive assessment, consumer perception, consumer benefits and consumer utilities are all important. Modern economic tools like conjoint analysis offer techniques to measure these consumer utilities and preferences. Utility for example is measured in terms of economic choices. In its simplest form, utility is revealed in people's willingness to pay different amounts for different goods. Thus, utility is defined as the satisfaction experienced by the consumer of a good that satisfies human needs.

In our hypothetical case, prices for out-of-home consumption in an Italian restaurant is one element in consumers' interest. Other elements are the satisfaction, fun and ease average families experience in having Italian food at a simple and close place nearby. Probably for average families, Italian restaurants are the first choice when going out for family dinner.

Post-merger the most likely result is that within the newly created duopoly prices will go up. We will also see an upgrade of the product range and services offered as well as a fancier restaurant. But is this exactly what the average families are looking for?

From the outset, the new combined offer (pizzas and pastas in one outlet) and the upgrade in services and products appear attractive. However, a more detailed economic analysis reveals that customers' utilities might decrease post-merger. Despite the price increases for Italian food which will be in the area of 30-40% (pizza price pre-merger €7; post-merger €9.80) families may face less utility post-merger in going to such a place. Since costs for dining out become more expensive, families will go less often. Spontaneous decision-making (like 'let's go!') are not possible anymore, because advance reservations and planning are required. The house-wine is gone and replaced by a list of exclusive wines making choices even more difficult. Maybe these families even perceive the red and white checked paper tablecloths as well as the simple furniture as utility-increasing since nobody really cares when the children mess around. The situation is different in an upmarket restaurant causing far more stress for parents with children. All these elements can be measured and influence customer satisfaction.

On the other hand, there will be a few new customers going to the fancy new restaurant who did not visit the simple Italian pizzeria or trattoria before. The utility of these new customers is increased but cannot compensate for the reduced utilities for the average families.

In any assessment, the efficiency gains created by the merger need to be compared with average customer utilities pre- and post-merger. The result is that the efficiency gains in this case do not outweigh the consumer detriments experienced by the average families in town.

Using a European School approach, remedies are likely.

One remedy could be, for example, that the new restaurant offers a take away facility at the lower prices they used to charge before. This can even be combined with an online-order business.

Another remedy could be that the newly created upmarket restaurant adds an additional outlet in the previous house-style next to the up-market restaurant for the local average families. Then it is up to the customer to decide which outlet he prefers: the chic new one or the traditional site.

In this sense, the European School represents from the customer/consumer perspective a holistic view by integrating the different utility elements of price, choice, quality and innovation in one assessment. However, what is decisive in an assessment in the European style is a fair re-distribution of the wealth gains between the market actors created by the merger.

To conclude, a competition policy in the European style focuses on social fairness and equality thereby preventing competition being destroyed by its own preconditions. Such a framework assures the free and fair play of the actors but also guarantees at the same time equal conditions for each actor and player.

Table 1: European School and Chicago School objectives: A Comparison

	European School: Implementation of the Social Market Economy objective in EU competition law	Chicago School
1.	Social policy objectives are included in EU competition law provisions (fairness and equality principles)	Social policy objectives are not included in antitrust law provisions
2.	School of thought is pre-defined in the law as a constitutional economic order	School of thought is flexible and not pre-defined in the law
3.	Companies with economic power need to behave in the same way as companies without economic power (equality principle): the focus is on 'competition on the merits' with special responsibilities	'Big is beautiful': dominant companies that innovate are rewarded for their efforts; new market entry is likely downplaying any economic power in the long run; no need to intervene
4.	Vertical agreements may create economic power to the detriment of consumers (fairness principle)	Vertical restraints are positive since they do not harm competition; They are even needed to increase innovation and service efforts and to control free riding
5.	Merger control: economic power post-merger is a concern; consumers' interests (price and quality related) are decisive (fairness and equality principle)	Merger control: economic power post-merger is of less concern; Company related efficiencies usually may outweigh any increase in market power
6.	Price fixing agreements might be permitted when consumers get a fair share of the generated benefits (fairness principle)	Price fixing agreements are *per se* illegal
7.	Focus on consumer utilities with respect to price, choice, quality, innovation, *et al*.	Focus on price theory only
8.	Welfare economics in the Marshallian tradition is not helpful; focus on the creation of wealth gains and the equal and fair re-distribution of these gains in society (fairness and equality principle)	Total welfare standard = consumer surplus + producer surplus; increase in producer surplus is enough to clear a merger even if consumer prices increase
9.	Antitrust authorities should be independent (fairness principle)	Political variations possible
10.	State Aid control: economic power can derive from private and public entities (equality principle)	No State Aid control at all