IPA
INSTITUTE OF PUBLIC ADMINISTRATION
A Recognised College of the National University of Ireland
Coláiste Aitheanta d'Ollscoil na hÉireann

Module:

Public Sector Economics

Lecturer:

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Monopoly and Regulation

"The best of all monopoly profits is a quiet life" J.R. Hicks

Monopoly Power & Society

- “The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself. That, in its essence, is Fascism—ownership of Government by an individual, by a group, or by any other controlling private power.
- The second truth is that the liberty of a democracy is not safe if its business system does not provide employment and produce and distribute goods in such a way as to sustain an acceptable standard of living.” Franklin Delano Roosevelt in a statement to the US Congress (1938)

Regulation–Monopoly

- Competition Policy is based on the belief in the economic benefits of competition
- Basic Assumption: Competitive market forces are the most effective means of ensuring efficiency (a) in allocation of resources, (b) maximising consumer welfare & (c) adapting to change

Regulation–Monopoly

- Efficiency is crucial to increasing living standards over time
- Competition regulation & law needs to be consistent to encourage competition and allow firms a degree of certainty but also flexibility to allow market power where it may be necessary on technical grounds

Competition Policy

- Competition advantages over monopoly
  - Static Benefits
    - more output at lower price (eliminates deadweight loss)
  - Dynamic Benefits
    - makes firms more efficient
    - Selection process – good firms grow, poor firms exit
    - Stimulates innovation

Competition Policy

- Competition advantages over monopoly
  - Equity Benefits
    - Small firms are protected from abuse of monopoly power
    - Monopoly profits skew distribution of wealth in society

Competition Policy

- A set of market attributes normally indicate the competition level in a market
  - Number and size distribution of sellers and buyers
  - Characteristics of the product and degree of market segmentation (e.g. product differentiation, horizontal and vertical restraints etc)
  - Entry and exit barriers

Competition Policy

- General Principles of Competition Policy
  - Highly concentrated market structures are more likely to be monopolistic
  - Competition problems not limited to certain sections of the economy
  - Direct benefits to consumer
  - Indirect benefits to up and down stream firms
  - Case by case studies necessary
  - Careful application of remedies required

Competition Policy

- Collective Anti-competitive behaviour
  - Horizontal Agreements
    - Fix prices
    - Carve up territory
    - Illegal *per se*
  - Vertical Agreements
    - Improve efficiency but dampen competition
    - Subject to rule of reason

Competition Policy

- Single firm behaviour
- Activities that
  - Unfairly raise rivals cost
  - Prevent an efficient firm from entering
- Are illegal

Competition Policy

- Regulation that effects market structure
  - Monopoly break-up
    - E.g. ATT, Standard Oil
  - Mergers and Acquisitions
    - Is competition severely damaged by the transaction?
    - Is there opportunity for new firms to enter?
    - Definition of market

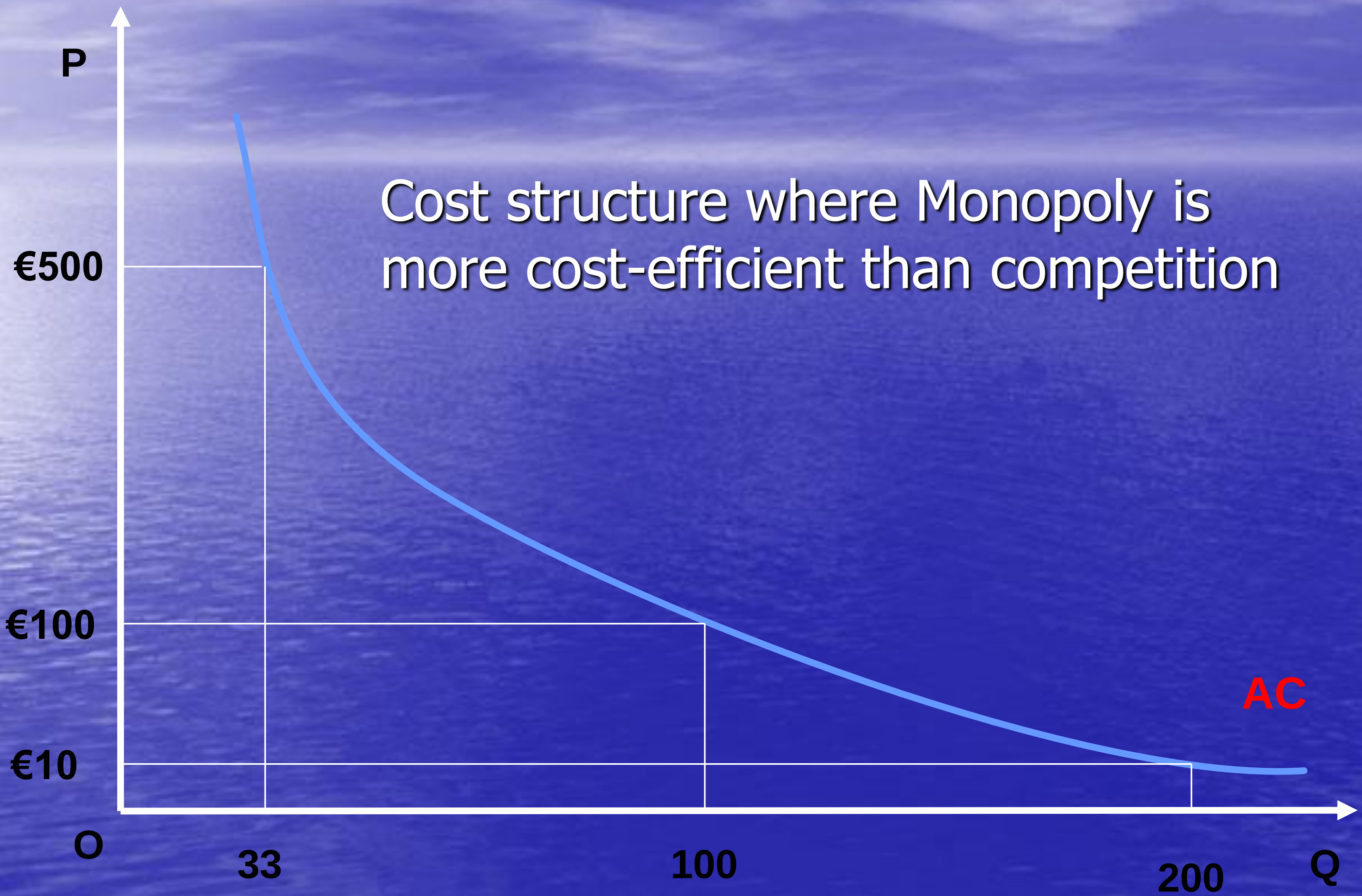
Regulation - Natural Monopoly

- Natural monopoly occurs when its is most efficient for one firm to supply the market
  - Entry & competition are not desirable
- Natural monopoly requires increasing returns to scale & a homogenous product
- Where natural monopoly is severe a specific regulator is required
  - Particularly where a natural monopoly & potentially competitive activities are intertwined

Regulation - Natural Monopoly

- Industries that require physical networks such as railways, electricity, gas, telecommunications, water/sewerage have a cost structure that consists of high fixed costs & low marginal costs (& therefore increasing returns to scale)
- These industries are crucial to the efficiency of the economy

Cost structure where Monopoly is more cost-efficient than competition



Regulation – Natural Monopoly

- Regulation of natural monopoly is required in three areas
  - Pricing
  - Access
  - Quality of service

Regulation - Natural Monopoly

- The regulator exists to move the market as close as possible to the competitive outcome
- This socially desirable outcome is where price equals marginal cost (allocative efficiency)
  - However MC is always below AC in a natural monopoly. The optimal social outcome occurs at a loss-making price
- Consequently, to price at the social optimum, a government subsidy can be provided
  - This can lead to inefficiency

Regulation–Natural Monopoly

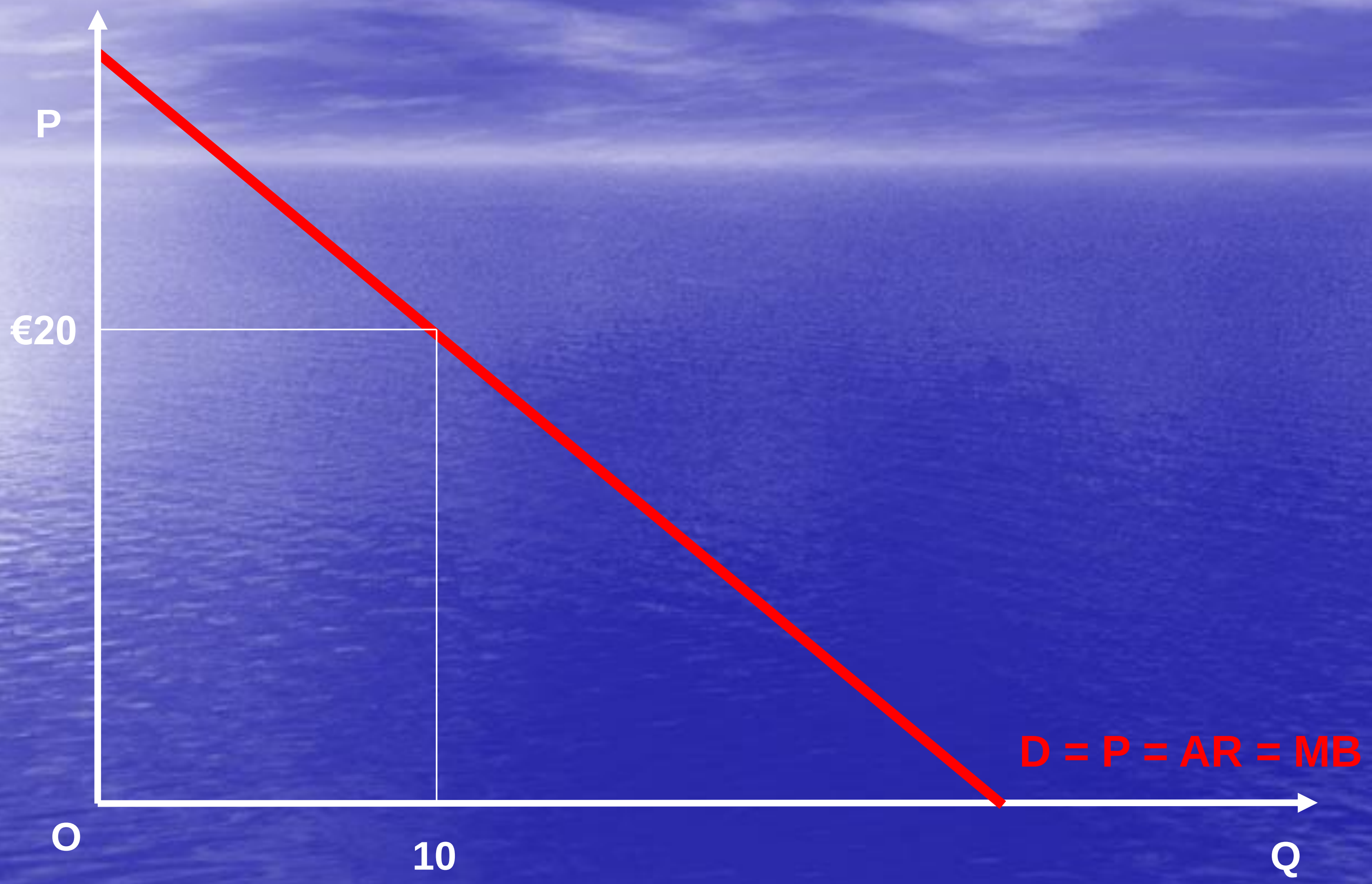
- Pricing – Pricing Regimes
  - Price=marginal cost
    - Government can subsidise firm's loss
    - Two-part pricing
  - Breakeven or average return on capital
    - Firm earns normal profit but open to x-inefficiency
  - RPI – X
    - Regulator allows price to increase by retail price index less "X" - the efficiency factor

Regulation - Natural Monopoly

- The regulator can stipulate a "Two-Part Pricing" schedule where the customer pays a fixed monthly fee and the price per unit consumed is set at marginal cost
- "Break-Even" pricing requires the price to be set price at average cost
- These pricing strategies are subject to X-inefficiency
- Costs can be increased through "managerial slack"

Regulation–Natural Monopoly

- In order to overcome inefficiency, the regulator sets the price at CPI-X
- The firm can increase their prices at the level of inflation minus an efficiency factor "X"
- Required to encourage innovation and ensure that producers keep prices and costs as low as possible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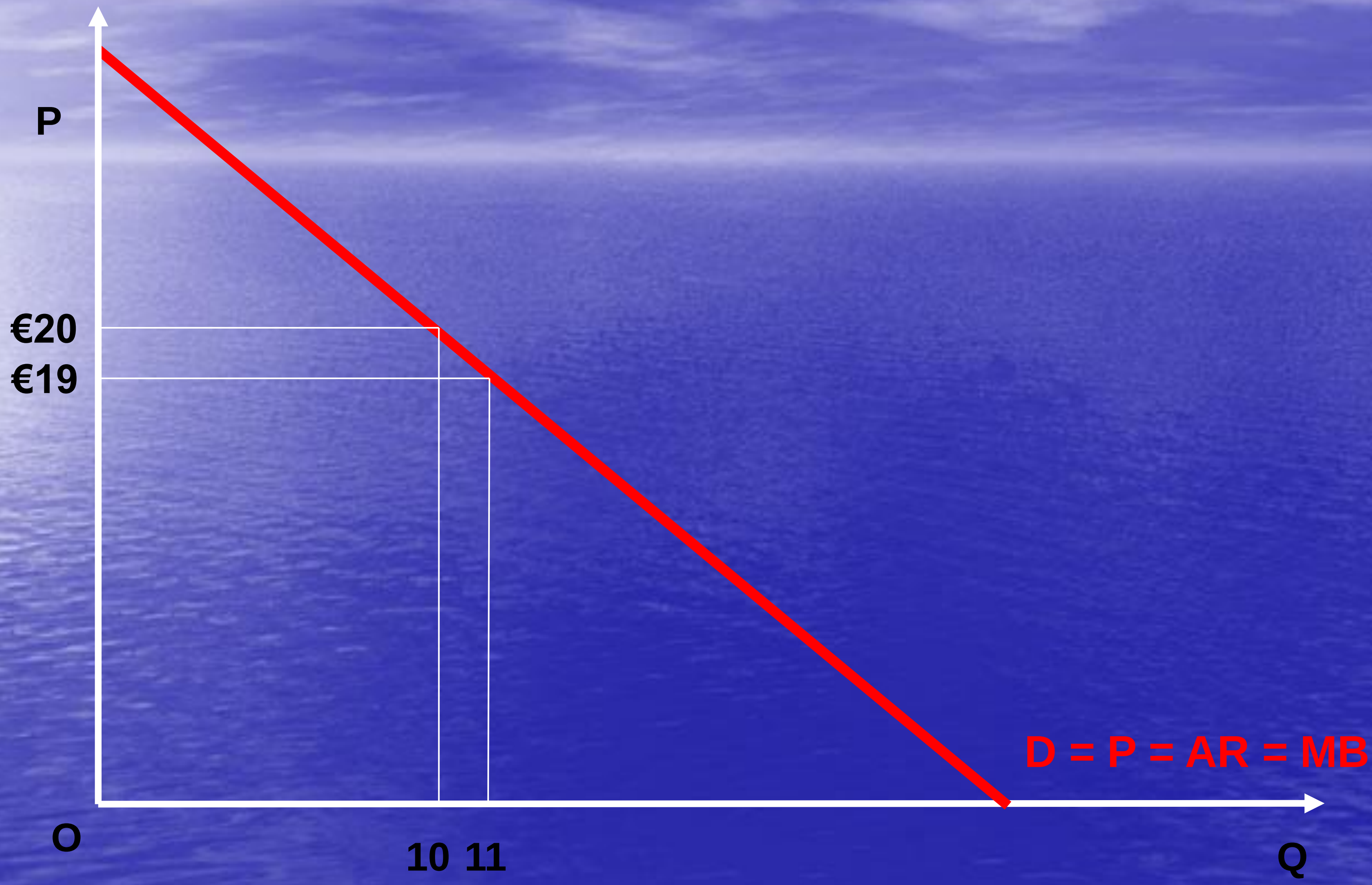
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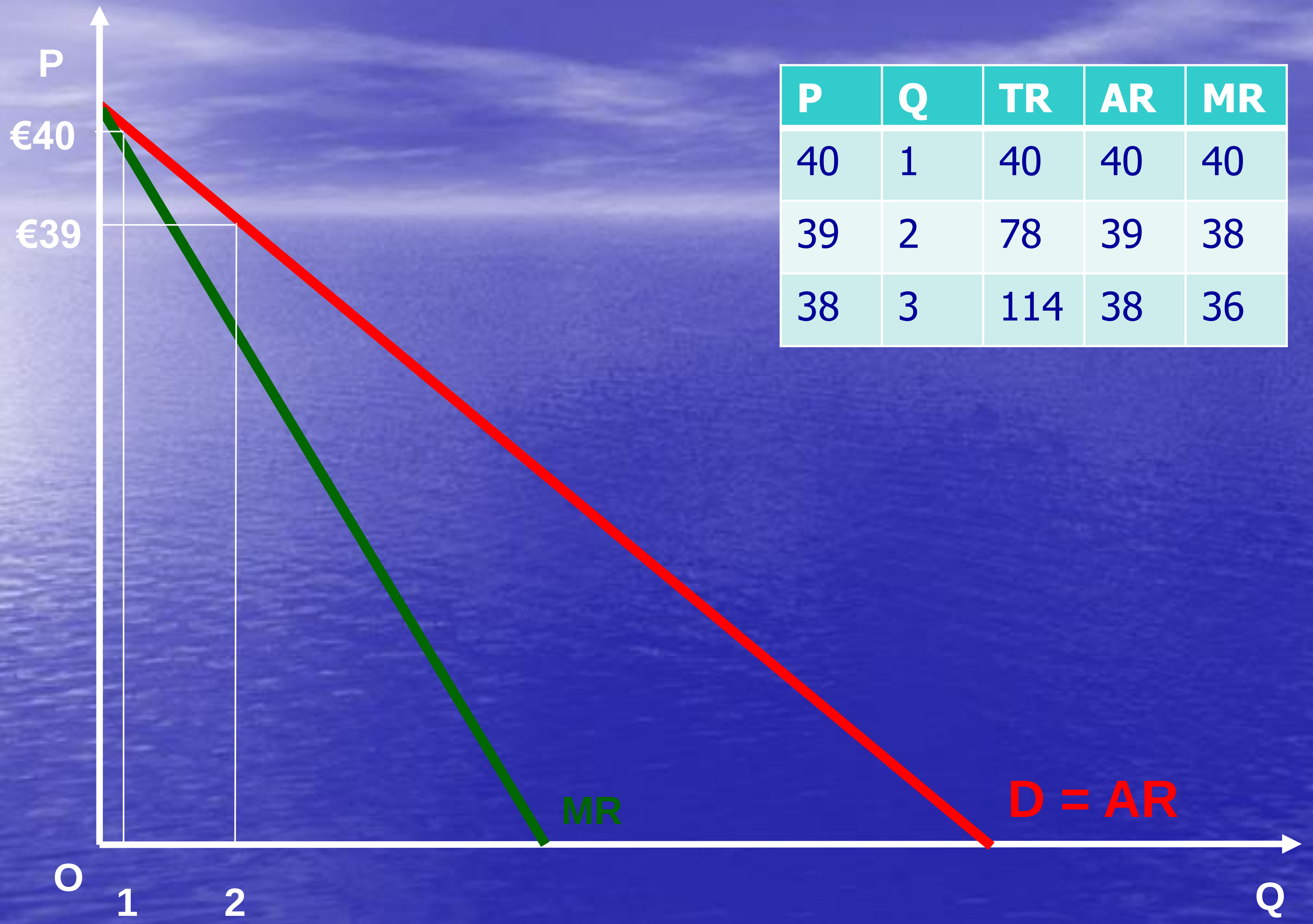
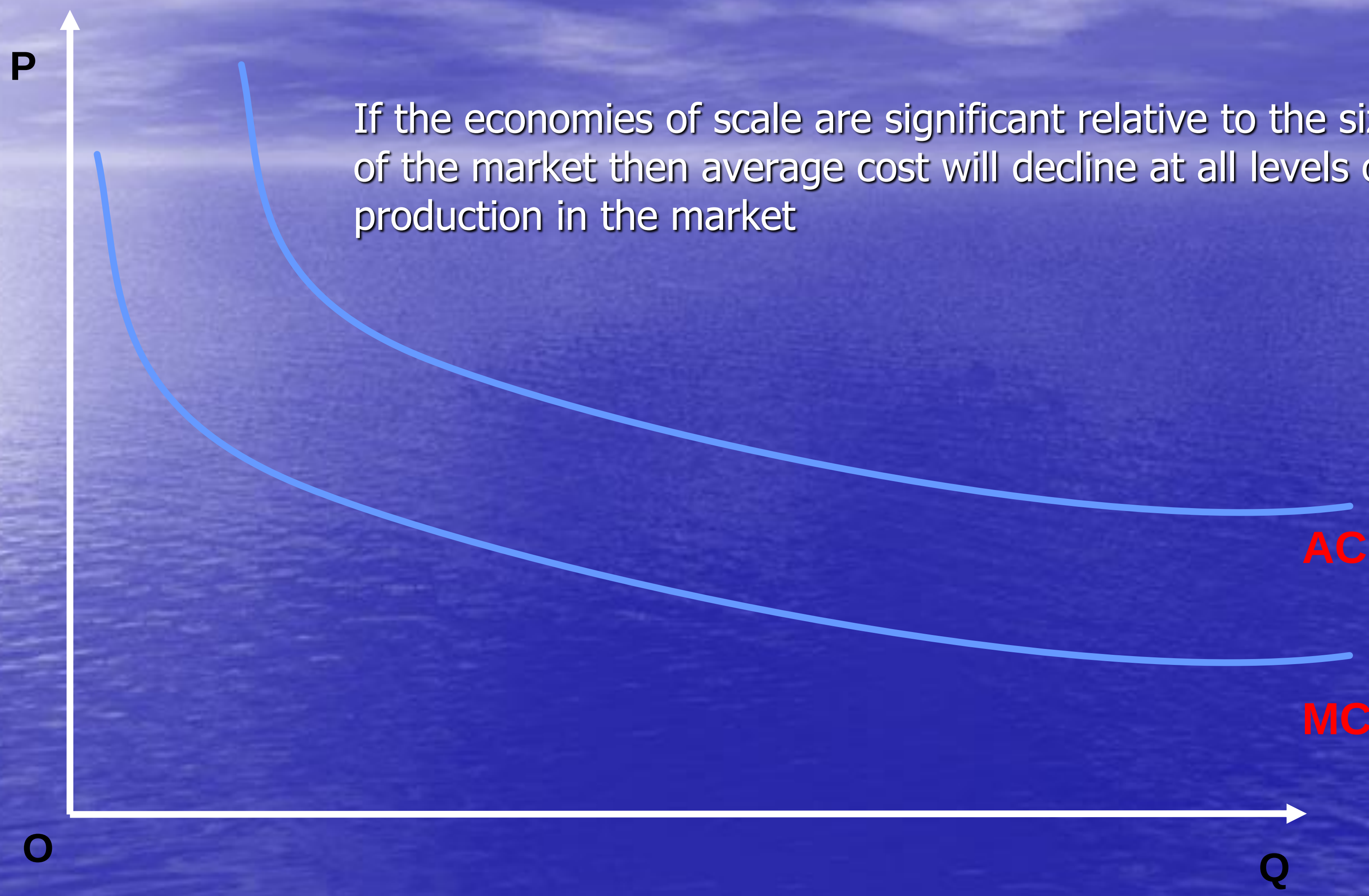
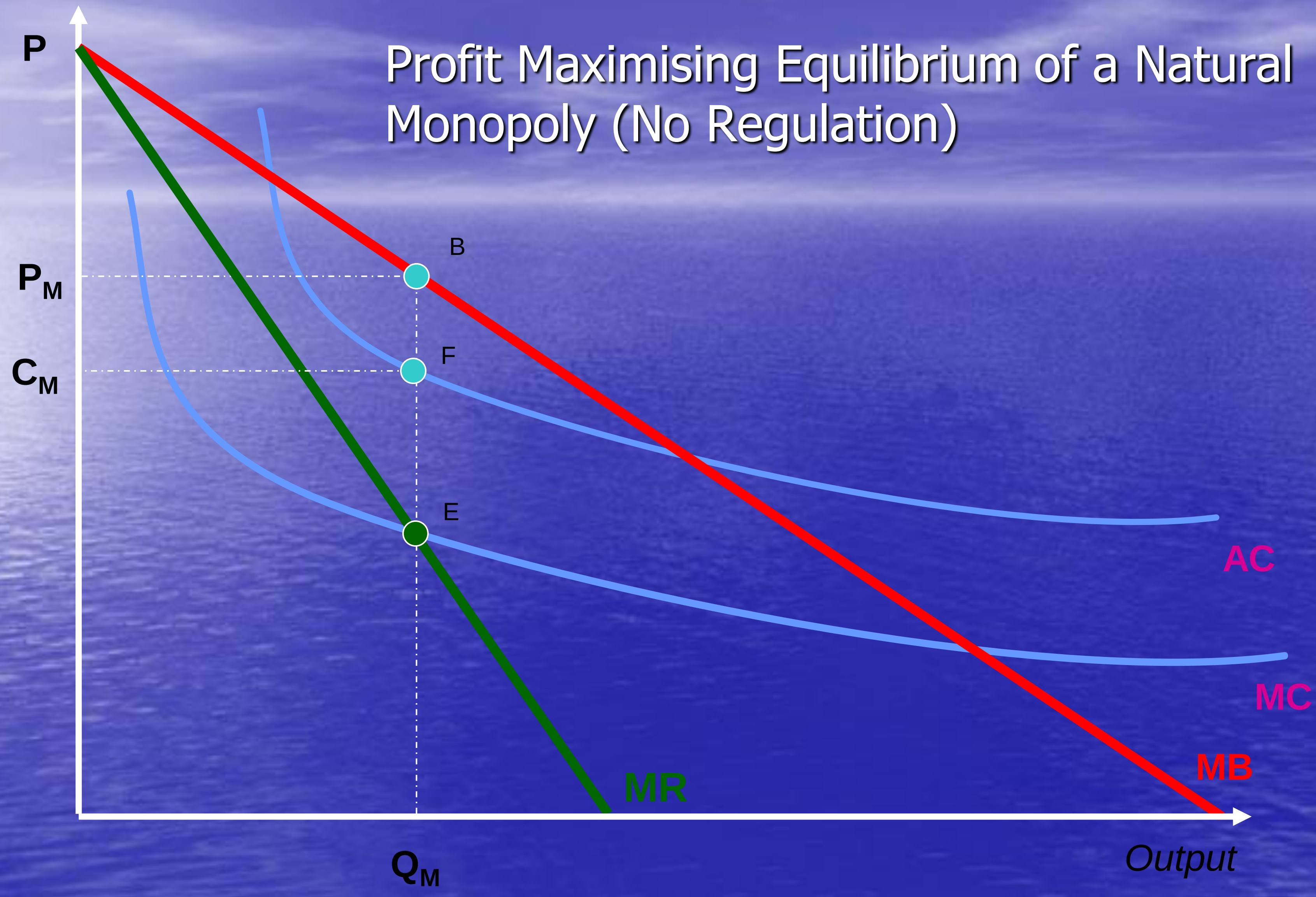


P	Q	TR	AR	MR
40	1	40	40	40
39	2	78	39	38
38	3	114	38	36

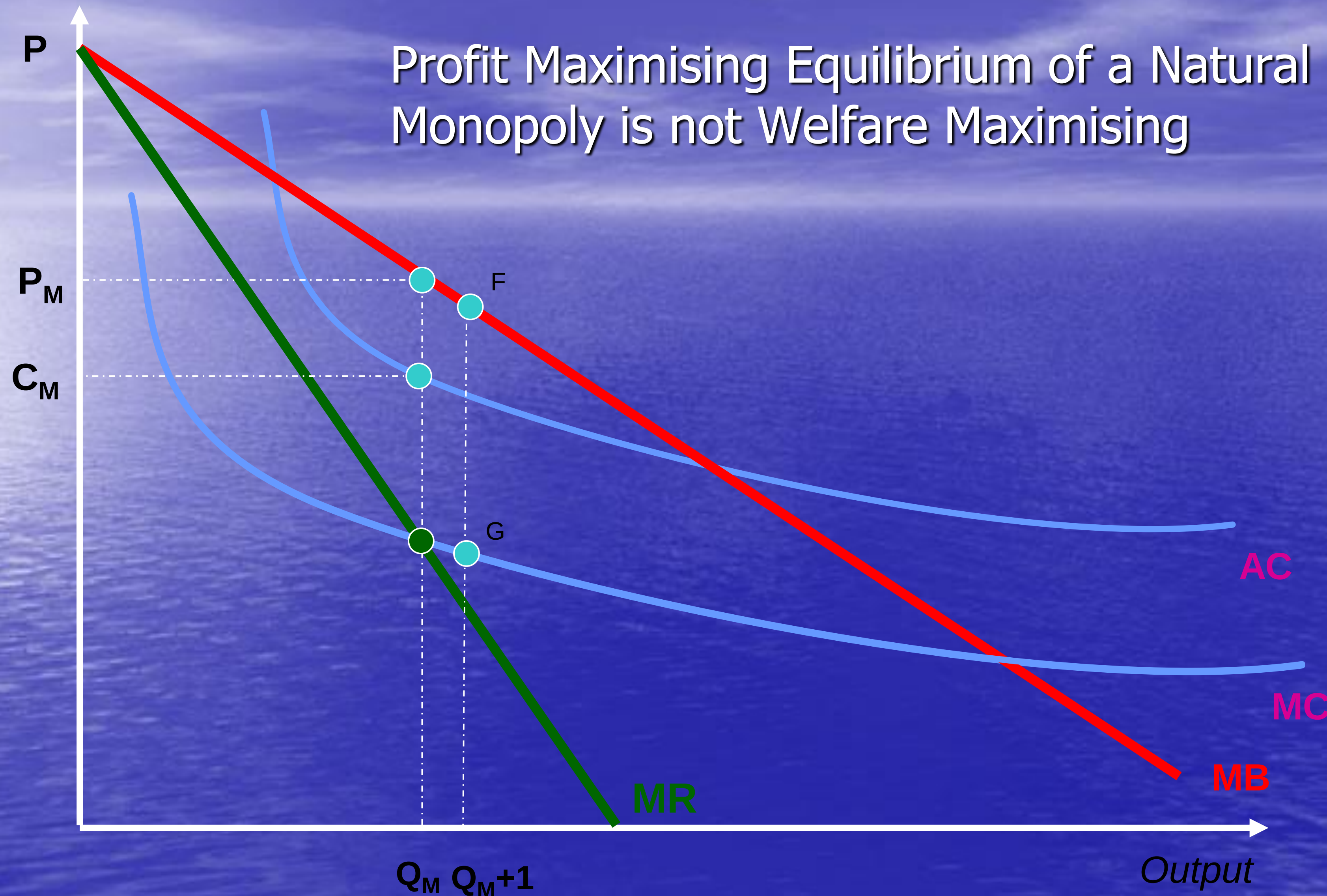
If the economies of scale are significant relative to the size of the market then average cost will decline at all levels of production in the market



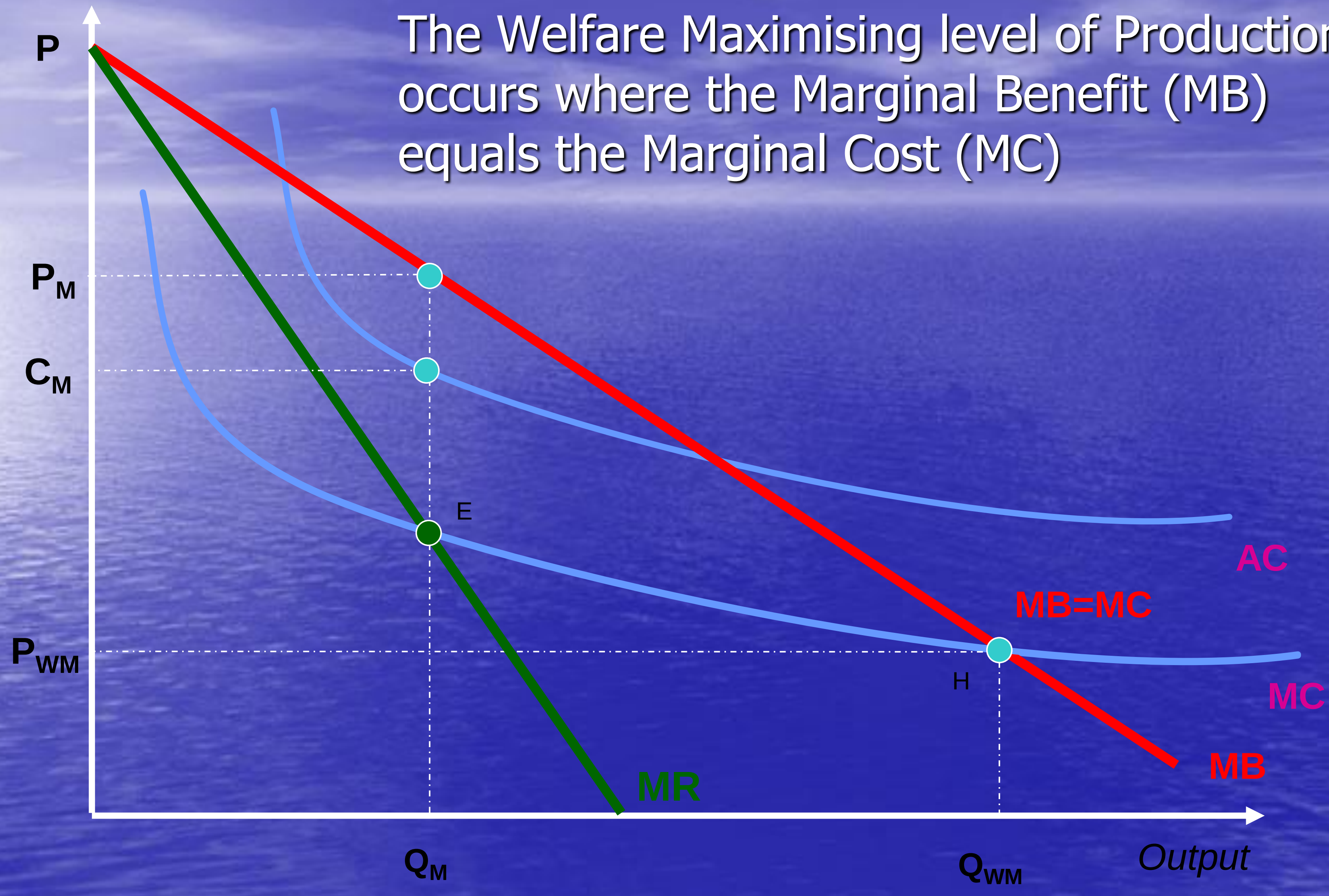
Profit Maximising Equilibrium of a Natural Monopoly (No Regulation)



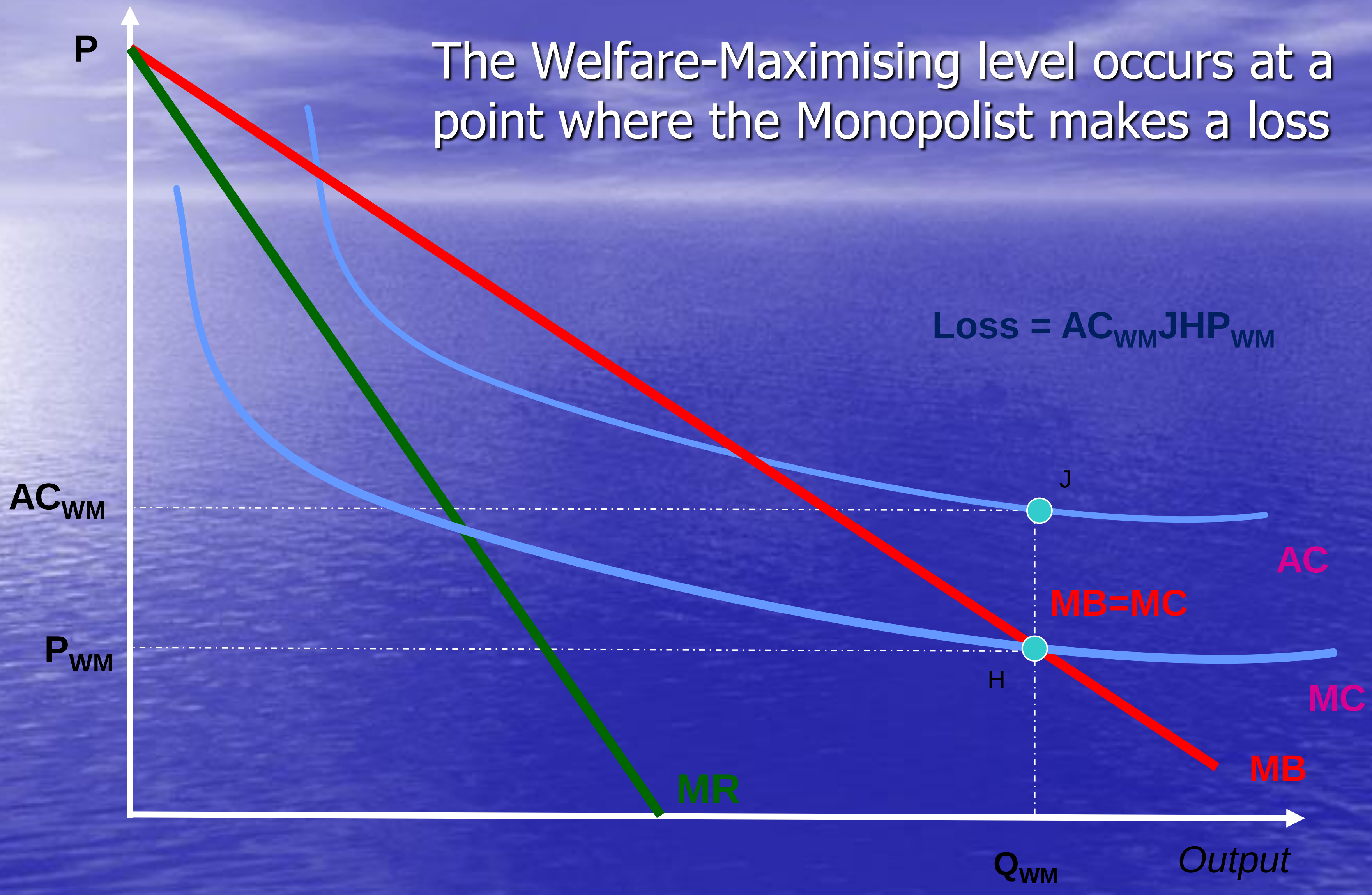
Profit Maximising Equilibrium of a Natural Monopoly is not Welfare Maximising



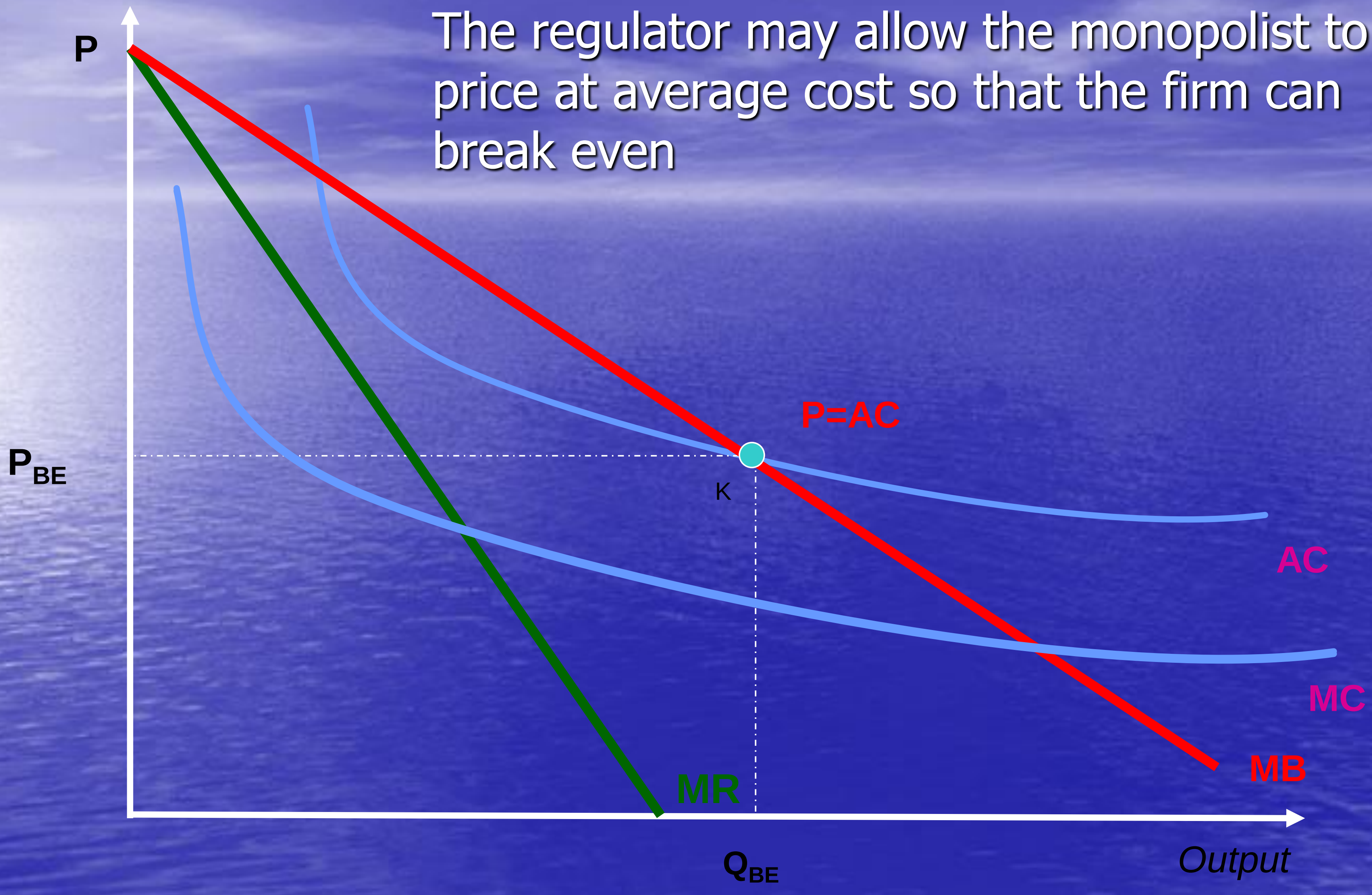
The Welfare Maximising level of Production occurs where the Marginal Benefit (MB) equals the Marginal Cost (MC)



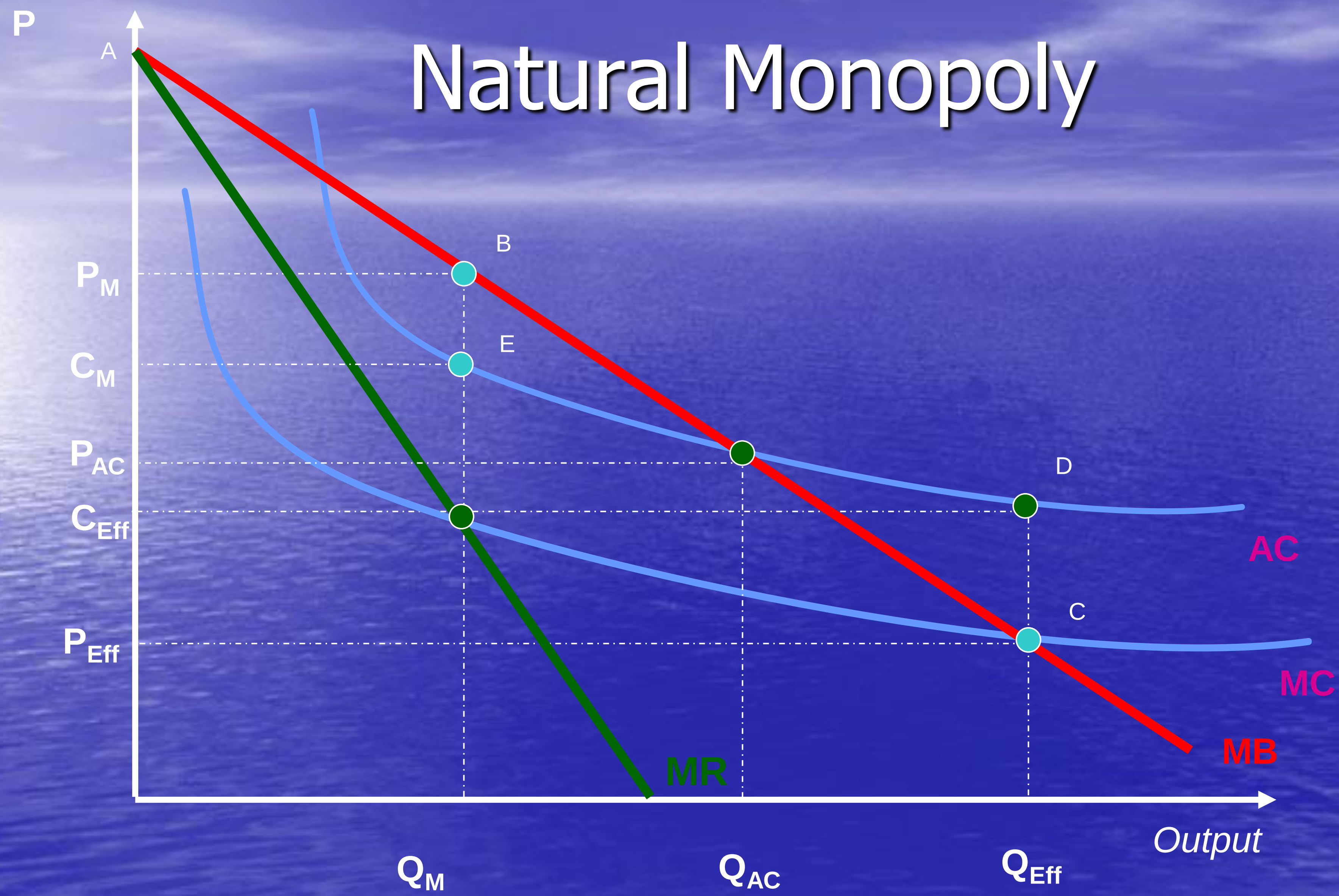
The Welfare-Maximising level occurs at a point where the Monopolist makes a loss



The regulator may allow the monopolist to price at average cost so that the firm can break even



Natural Monopoly



Regulation–Natural Monopoly

- Access
  - Network monopolist must allow fair access to up/downstream firms
  - Monopolist must not be allowed favour it’s up/downstream subsidiary
  - Efficient component pricing rule (ECPR) i.e. marginal cost + contribution to fixed cost

Regulation–Natural Monopoly

- Quality of service
  - Universal service obligations (USO) i.e. supply a minimum set of services of specified quality to all users at an affordable price
  - Competitors mustn't be allowed to cherry pick
  - Natural monopolist must provide uniform service to all competitors
  - Quality of service to consumer