Competition and Antitrust

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This presentation draws on ideas from Professor Porter’s books, in particular, Competitive Strategy (The Free Press, 1980), Competitive Advantage (The Free Press, 1985), “What is Strategy?” (Harvard Business Review, Nov/Dec 1996), The Competitive Advantage of Nations, and other publications cited. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means - electronic, mechanical, photocopying, recording, or otherwise - without the permission of Michael E. Porter.
“...countries where the intensity of competition is rising showed by far the greatest improvement in GDP per capita.”

Competition and Prosperity
Evidence from Japanese Industry

Sakakibara/Porter:
“We find a positive and highly significant relationship between the extent of market share fluctuations [a measure of local rivalry] and trade performance.

Contrary to some popular views, our results suggest that Japanese competitiveness is associated with home market competition, not collusion, cartels, or government intervention that stabilize it.”

Goals of Antitrust Policy

Traditional View
- Profitability (allocative efficiency)
- Cost (static efficiency)
- Innovation (dynamic efficiency)

Alternative View
- Innovation (dynamic efficiency)
- Value improvement (static productivity)
- Profitability (allocative efficiency)

Profitability standard
Productivity growth standard
Productivity

- Productivity depends on both value (price) and cost

  ![Diagram showing Buyer Value and Unit Cost](attachment:diagram.png)

  (premium price)

- Productivity analysis considers the **trajectory** of product value and cost, not only current profitability
  - profitability for successful firms is a sign of healthy competition if it is a reflection of truly superior products or significant advantages in operating efficiency
- Productivity captures the broader connection between competition and standard of living
- Improvements in productivity depend on **healthy competition**
- Mergers and other corporate practices that materially improve product value or raise fundamental operating efficiency are likely to be good for society, unless they give rise to significant risks to competition itself
Assessing the Extent of Competition
Five Forces Model

- Threat of Substitute Products or Services
- Bargaining Power of Suppliers
- Rivalry Among Existing Competitors
- Threat of New Entrants
- Bargaining Power of Buyers
Assessing the Extent of Competition
Five Forces Model

Threat of Substitute Products or Services

Determinants of Substitution Threat
- Relative price performance of substitutes
- Switching costs
- Buyer propensity to substitute

Determinants of Supplier Power
- Differentiation of inputs
- Switching costs of suppliers and firms in the industry
- Presence of substitute inputs
- Supplier concentration
- Importance of volume to supplier
- Cost relative to total purchases in the industry
- Impact of inputs on cost or differentiation
- Threat of forward integration relative to threat of backward integration by firms in the industry

Determinants of Substitution Threat
- Relative price performance of substitutes
- Switching costs
- Buyer propensity to substitute

Rivalry Among Existing Competitors

Rivalry Determinants
- Switching costs
- Informational complexity
- Diversity of competitors
- Corporate stakes
- Exit barriers

Bargaining Power of Suppliers

Bargaining Power of Buyers

Bargaining Leverage
- Buyer concentration vs firm concentration
- Buyer volume
- Buyer switching costs relative to firm switching costs
- Buyer information
- Ability to backward integrate
- Substitute products
- Pull-through

Entry Barriers/Mobility Barriers

- Economies of scale
- Proprietary product differences
- Brand identity
- Switching costs
- Capital requirements
- Access to distribution

Price Sensitivity
- Price/total purchases
- Product differences
- Brand identity
- Impact on quality/performance
- Buyer profits
- Decisionmakers’ incentives
Rivalry and Productivity Growth

Imitation and Price Discounting

• Low prices

• Little true customer choice

“Zero sum competition”

Strategic Differentiation

• Multiple, different value propositions

• Expanded market

“Positive sum competition”
Assessing the Extent of Competition
Five Forces Framework

Advantages
• Embodies a much broader conception of competition
• Embodies a much richer conception of rivalry
• Can apply to any market definition
• Fact-based analysis unique to each industry
• Allows analysis of both near-term and longer-term effects

Issues
• Requires the weighing and balancing of numerous elements (an expert system)
• Quantification of the net effect of competition is difficult
• Five forces should not be used in isolation, but as part of a risk-reward analysis
The Externalities of Rivalry
Determinants of Productivity and Productivity Growth

- A local context that encourages investment and sustained upgrading
- Open and vigorous competition among locally based rivals

Factor (Input) Conditions
- High quality and specialization of inputs available to firms:
  - human resources
  - capital resources
  - physical infrastructure
  - administrative infrastructure
  - information infrastructure
  - scientific and technological infrastructure
  - natural resources

Demand Conditions
- Sophisticated and demanding local customer(s)
- Unusual local demand in specialized segments that can be served globally
- Customer needs that anticipate those elsewhere

Related and Supporting Industries
- Presence of capable, locally based suppliers and firms in related fields
- Presence of clusters instead of isolated industries

The California Wine Cluster

Grapes

State Government Agencies
(e.g., Select Committee on Wine Production and Economy)

Growers/Vineyards

Winery/Processing Facilities

Educational, Research, & Trade Organizations
(e.g., Wine Institute, UC Davis, Culinary Institutes)

Winemaking Equipment

Barrels

Bottles

Caps and Corks

Labels

Public Relations and Advertising

Specialized Publications
(e.g., Wine Spectator, Trade Journal)

California Agricultural Cluster

Fertilizer, Pesticides, Herbicides

Grape Harvesting Equipment

Irrigation Technology

Educational, Research, & Trade Organizations
(e.g., Wine Institute, UC Davis, Culinary Institutes)

Tourism Cluster

Food Cluster

Sources: California Wine Institute, Internet search, California State Legislature. Based on research by MBA 1997 students R. Alexander, R. Arney, N. Black, E. Frost, and A. Shivananda.
Productivity Growth Test

• Innovation and dynamic improvement is more important than static efficiency
  – e.g., the accessibility of the market to new entrants/small rivals is **weighted higher** than reaping static economies of scale, especially due to fixed cost or administrative overhead amortization
  – short-term price cuts are evaluated in light not only of current costs but also vs. the trajectory of productivity
  – transient efficiency gains such as lowering the risk of capacity shortages are discounted if there is any significant potential effect on competition

• Cluster externalities are important to productivity and productivity growth
  – **national** conditions are important even in global markets
  – vertical foreclosure can be reevaluated using this framework

• If a risk to competition is identified, the burden shifts to the company to document productivity and productivity growth benefits. Evidence from **customers** is accorded special weight
Hierarchy of Productivity Enhancement

- **Buyer Value**
  - Product/service quality and features
  - Breadth of product offering independent of quality/features
  - Brand identity

- **Cost**
  - Operating costs
  - Fixed/semi-fixed costs (e.g., advertising, service locations)
  - Overhead/administrative costs

• Customer satisfaction is an important sign of healthy competition
Standards for Merger Approval

- Mergers and other combinations should be treated with caution versus other corporate growth strategies

- Acquiring another company requires only capital and no new products, technologies, processes, or marketing approaches.

- The empirical evidence is striking that mergers have a low success rate.

- Strategy research reveals that smaller, focused acquisitions are most likely to improve competitive fundamentals vs. mergers among leaders.

- Reducing the number of significant rivals is much more likely to reduce competition than increase it.
Standards for Merger Approval (cont.)

• What is the likely near-term and long-term effect of the merger on competition?
  – a (low) minimum share threshold is used to screen out small transactions
  – five forces analysis
  – all relevant markets/submarkets
  – diamond analysis of externalities

  No material effect on competition  Significant effect on competition

• How will the merger affect productivity and productivity growth?
  – the burden of proof is on the companies to demonstrate lasting, fundamental productivity benefits (e.g., operating vs. corporate overhead savings)

• Are the productivity benefits significant enough to outweigh the threat to competition?
  – risk/reward analysis
Standards for Merger Approval (cont.)

- elimination of pooling of interest
- stricter rules on merger write-offs and restructuring charges
- modifications in reporting requirements (e.g., requirements to report equity before write-offs and charges in the previous five-year period)
- collection and reporting of systematic information on merger outcomes (e.g., durability, profitability, customer satisfaction, quality and service metrics)
Evaluating Competitive Practices

NutraSweet

NutraSweet Practices

• Patent on blends of aspartame and saccharin -- blending by customers not permitted by NutraSweet
• Aggressive investment in brand
• Joint venture with a potential competitor (Ajinimoto)
• Branded ingredient strategy
• Heavy investment in other sweeteners
• Exclusive multi-year contracts with large customers (meet or release; most favored nation clauses)

• NutraSweet began serious cost reduction
• Aggressively expand capacity ahead of demand
• Aggressive price reductions below total cost

Market Outcomes

• NutraSweet retains dominance
• Lower prices/profits
• NutraSweet cost reduction does not begin until new entrant appears
• Blending suppressed -- taste and health benefits
• Several potentially superior sweeteners never developed
• Tosoh (Japan) production process for aspartame never commercialized
• Ajinimoto never became a significant competitor
• Little innovation in the industry after the competitive threat repelled

Industry Structure

Suppliers
• Benign

Barriers to Entry
• Moderate to high

Rivalry
• Low variable costs

Substitutes
• Many alternative sweeteners under development
• But high switching costs

Buyers
• Powerful soft drink companies

Source: Bitter Competition: The Holland Sweetener Co. vs. NutraSweet (A), Harvard Business School case #794079
Evaluating Competitive Practices

How substantial is the competitor? (an indication of potential effect of the practice on overall market)

- Small competitor
  - Is the practice likely to be widely imitated?
    - No
      - No antitrust issue
    - Yes
      - Further review

- Major / leading competitor
  - Note: dominant competitors should face a higher standard
  - Further review
Evaluating Competitive Practices (cont.)

How does the practice affect industry structure?

- **Benign/positive**
  - No antitrust issue

- **Negative**
  - Risk/reward assessment

How does the practice affect cluster externalities?

- **Benign/positive**
  - No antitrust issue

- **Negative**
  - Risk/reward assessment

Does the practice significantly improve customer value?

- Additional test: presumption of customer choice vs. producer foreclosure of choice

- **Yes**
  - Is the benefit significant enough to offset the competitive risk?

- **No**
  - Will the benefit be passed on to the customer?

Does the practice significantly improve operating productivity?

- **Yes**
  - Is the benefit significant enough to offset the competitive risk?

- **No**
  - Practice prohibited