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Integration sometimes stacks up

Sep 06

Joshua Gans

In a recent speech, the chairman of the Australian Competition and Consumer Commission, Graeme Samuel, raised concerns about the level of vertical integration in telecommunications.

Indeed, he went so far as to suggest that competition in telecommunications would be greatly improved if Telstra were to divest its cable network - a principal means of delivering cable television and broadband internet services.

This follows the ACCC's high-profile attempt to prevent retailer AGL acquiring a stake in a generator, Loy Yang A.

The Federal Court found against the ACCC. Nonetheless, ACCC commissioner Ed Willett has reiterated his concerns regarding increasing levels of integration in the electricity sector and called for more powers to regulate the structure of that industry.

Given this heightened level of awareness regarding vertical integration, it appears timely to consider the basic economic forces at work. Put simply, unlike price fixing and collusion, and more so than mergers between competitors, vertical integration has always been a difficult call for regulators.

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reduces the costs of bringing a product to market is likely to make a firm a more aggressive competitor and yield consumer benefits.

For us to consider whether vertical integration could achieve such efficiencies we have to ask the alternative: why can't separate entities do the same?

Consider a situation when a retailer could make some key investments that improve demand for a supplier's product. If the supplier owned the retailer (that is, there was integration), it could simply make the investment and bear the relevant costs. Without integration, the retailer must bear

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investment costs with some of the benefits accruing to the supplier. Absent any other arrangement, this might deter some productive investments. However, in many situations, a contract between the two parties could secure the necessary payments to ensure the investment went ahead. So if the relevant actions are contractible, then a lack of integration is not an impediment to efficiency and integration doesn't enhance it.

But what if the investment involves effort and other decisions (for example, quality control, creativity and so on) that can't be easily put into a contract? By owning another set of assets in the vertical production chain, there can be a more favourable aligning of incentives. This might include incentives with respect to pricing; whereas a separate upstream firm might charge retailers a mark-up, if they were integrated this could be avoided. In the end, costs are lower and efficiencies are achieved.

What this means is that assessing the competitive impact of a vertical merger is going to be difficult if there are lots of key decisions and investments that are hard to contract over. But what about when that isn't the case? After all, it is arguable that in electricity, retailers and generators perform very distinct functions and that the cable and copper network operations have little to do with one another.

The simple anti-competitive story regarding vertical integration is that an integrated firm may choose to foreclose on rivals (raising prices or excluding them), thereby impeding competition and leading to consumer harm. A bottleneck monopolist has the ability to foreclose on rivals. By denying them supply or access to key markets, their business can be curtailed.

But even in this situation, the incentive may not be there. An independent retailer may have, say, a valuable brand and the monopolist may be better off dealing with them than relying on internal selling. So it is the monopoly that is the problem rather than its integrated status.

Moreover, cutting off supply is only effective if a firm has no other supply sources. When there is no monopoly segment or there is the possibility of imports from other regions, any attempt at foreclosure merely results in lost sales without any competitive shielding for its own retail units.

It is on this question of alternative sources of supply that the ACCC's concerns in electricity and telecommunications appear to be highly valid from an economic perspective.

In the case of telecommunications, there are potentially insufficient alternative supply sources. Telstra owns both major telecommunications networks in copper and cable. Separation of the two would provide incentives for new providers that use these networks to come into the market, giving them options as to how they enter and who they deal with. This would lead to the evolution of a more competitive and innovative telecommunications industry.

For electricity, the case is more subtle. The whole premise of separating generation from distribution was that the latter could operate through an easily accessible spot market. Nonetheless, generators and retailers both need hedge contracts to manage risk and compete effectively.

In the absence of integration, those contracts are freely available for established firms and potential entrants alike. But if a retailer buys a generator, their risks are naturally hedged and the need to trade explicit

contracts goes away. When large players merge, the liquidity of the contract market can be substantially diminished.

Herein lies the ACCC's concern. In the absence of another productive reason, one by one, retailers and generators could hook up. The contract market would become thinner and thinner, until - as AGL itself has found in New Zealand - non-integrated retailers and generators could not obtain sufficient hedge cover to manage their risks.Then you have to be integrated in both to have a chance and the long-term prospects for increasing competition become bleak.

The problem is that our Trade Practices Act may not be equipped to deal with these problems. In contrast with the US, divestiture of long-standing integrated firms is not a solution our courts rely upon. Moreover, creeping integration can be difficult to assess if each acquisition is analysed in isolation. We need to answer calls to consider amendments to our competition laws to deal with this.

Nevertheless, there are risks associated with blanket approaches to vertical integration. Unlike other restrictive practices, vertical integration is not the root of all evil and is not, in itself, a source of power. However, at the moment, the ACCC has not issued any guidelines regarding what types of vertical mergers would trigger competition concerns. Business is still operating in a vacuum on this topic, unable to forecast when a regulatory barrier may be raised. On this score at least, providing more certainty is within the control of our competition regulator.

- *Joshua Gans is professor of management (information economics) at Melbourne Business School, University of Melbourne. For more writings on this topic see http://www.economics.com.au.*

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