Markets without substitutes

Substitution versus constraints as the key to market definition

A market consists of products which are close substitutes, or so it is said. Yet there are numerous examples where competition law markets do not consist of products which are substitutes, or interchangeable in use, or even in the same 'market'. Here the why, when and implications are spelt out.

The formal definition

The EC *Market Definition Notice* (para 7) follows the European courts by stating that: *'A relevant market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use.'* Translated into economics this confines a relevant market to products which are close substitutes in the eyes of consumers (more technically those with a high cross price elasticity of demand). The more recent approach - the SSNIP test – adds the appearance of empirical certitude by including pre-set price changes in the definition – it ties substitution to changes in relative prices. But as we shall see this focus on the direct substitution between two or more products can be misleading and misplaced.

Markets with complements

One example where markets are not confined to close substitutes are so-called 'aftermarkets'. These consist of products that are not physically interchangeable but are complements. An aftermarket can arise where a primary hardware product (computer or photocopier) needs consumables (software updates, toner) and after-sales services. Under some assumptions the physical product and the consumables can be in the same relevant product market and not different ones (see [Casenote,October 1998]). This arises where consumers take into account the costs of both the hardware and the consumables when they make their initial purchase. In this way sales in the primary market constrain the prices of complementary consummables and services.

Bundled products provide another example where markets may not include substitutes. Product bundling can lead to markets consisting of a range of complementary products. Here the conditions are usually fairly stringent requiring evidence that the bundled service is not easily substituted for by its standalone components.

'Cluster markets' are another example. This is where a bundle of services are marketed and consumed as one 'product'. The basic service provided by retail banks can be seen in these terms. These typically consist of a package of services - chequing/savings accounts, payment services (direct debit, standing orders, ATM), overdraft facility, cash and debit cards etc.. The basis for this market definition is transactional efficiency in bundling such services.

Perhaps less controversial is the chain of substitution analysis which places products which are not direct substitutes in the same relevant product market. Products which differ greatly in quality and price – such as hotels (backpackers' hostel and The George) and cars (2CV and Bentley) – can be part of the same relevant product market. This relies on substitution at the margin between different categories of products – A with B, B with C, C with D - and ergo A with D, even though someone buying product D (Bentley) would not regard product A (2CV) a direct substitute.

The collapse of functional markets

Products at different levels of the supply chain provide some interesting and counter-intuitive examples of market definition. The distinction between retail and wholesale is widely accepted. Yet the treatment of 'functional' markets is not often straightforward. This is because upstream and downstream markets are related. Indeed the demand for an upstream product or input is derived from the demand for the final product, and this can sometimes bind two upstream inputs which are not direct substitutes for one another, and/or even the wholesale and retail markets.

To illustrate the first possibility consider the use of rice to produce Mao Tai (a Chinese rice spirit). If rice is used as the starting point for market definition, then applying the SSNIP test to the price of rice will find that producers of Mao Tai will not (and cannot) substitute another grain or fruit. Thus, rice becomes a relevant input market. However, if it can be shown that consumers regard other spirits (cognac, brandy) as close substitutes for Mao Tai, then they will substitute these spirits in response to an increase in the relative price rice and hence of Mao Tai. This, in turn, will mean that rice used to make Mao Tai is not a relevant input market if the indirect substitution effect at the retail level is sufficiently strong. The hypothetical monopolist of rice used to make Mao Tai may not be able to profitably raise its price because consumers will turn to other types of spirits which they regard as close substitutes. The relevant input market is therefore wider than rice and includes grapes and plums used in the production of the other spirits even though these cannot be used to produce Mao Tai.

The Mao Tai example perfectly captures the competitive analysis often deployed to place cable and ADSL broadband access in the same market even though cable operators do not allow third party access to cable networks. This is because at the retail level consumers regard cable and ADSL broadband as close substitutes.

A variant on the above can make apparently thriving wholesale markets disappear from a competition law perspective. In the Australian case *Seven v News* the claimant argued that there was a market for wholesale sports channels as it had set one up in competition with sports channels run by the dominant pay TV operator. The respondents countered (and the court accepted) that there was no wholesale sports channel market as the pay TV operator could easily bid for the same sports rights to develop its own sports channel thus preventing an third party sports channel provider from raising the price above the competitive level. Thus the ability of the pay TV operator to easily set up a sports channel placed retail and wholesale operations in the one **retail** sports channel market.

One can be more specific about the interaction between retail and derived input demand. The economic 'laws' of derived demand (as set out by economists Marshall, 1920; and Hicks, 1966) state that, all other things equal, the own price elasticity of demand of an input is high if the following conditions exist:

1. the price elasticity of demand for the end product is high;
2. other factors of production can easily by substituted for the input;
3. the elasticity of supply of other inputs is high; and
4. the costs of employing the input are a large share of total production costs.

Factors 2 and 3 (together with 4) cover the direct substitution effect; while 1 and also 4 the indirect effects or indirect constraints approach.

Implications

The indirect constraints approach has been accepted in EC competition law (*Schneider/Legrand* and *GE/Honeywell* CFI appeals, *Bronner* and *Commercial Solvents,* and the EC *Access Notice* (1998).

The indirect constraints approach has major implications for market definition and competitive analysis. First, it qualifies the proposition that market definition should start with the product at the heart of a competition claim. For input/wholesale markets this is clearly not the case. The starting point is the downstream market not input market. Applying the SSNIP test to inputs would only identify the direct substitute effects and miss the indirect constraints exerted by competition at the retail/end product level.

Second, it has played a key role in undermining the attempt to establish an EU essential facility doctrine. The courts were quick to appreciate that the 'essentiality' of an input cannot be determined by simply noting that only one input can be used to produce the product or service in question. In *Bronner* the AG's Opinion stated (correctly) that it was not upstream competition which was the critical in determining whether an input (newspaper distribution networks) was 'essential' but competition in the downstream service market (newspapers). If there are sufficiently close substitutes downstream, then it is not an abuse to refuse to supply access to the facility because it is not essential to downstream competition.

Conclusions

These examples illustrate that markets in competition law are not solely about products or services which are direct substitutes. They are about products and services which place a competitive constraint on one another, and these may be products which are complements, at different levels in the supply chain, and sometimes (magically) make a real world market disappear. It also points to the danger of the frequent approach to input and wholesale markets which focuses on direct substitution effects and ignores the indirect constraints exerted by the downstream market(s).

Dr Cento Veljanovski +44 (0) 20 7376 4418 or cento@casecon.com