"Compare and contrast the various methods of dealing with the problem of monopoly."

Legally, a working Monopoly is defined as a firm which controls 25% of their market. This immediately raises problems, within the measurement of market share, and the definition of their market. Microsoft is a considerably well known monopoly (as a whole), but is this the case for all areas of business? This would be the initial problem: determining their market. Microsoft spans a vast spectrum of business, however, virtually breaking into distinct main markets – Desktop and Server. It is clear that Microsoft dominate the Desktop market, far outselling any near threats, but is this the case for the server market? I have broken down the server market into two main areas – the Operating System itself, and the web based server.

Operating System	*Percentage Share*
Linux	31.3%
Microsoft Family	24.3%

Server Software	*Percentage Share*
Apache Foundation	56%
IIS (Microsoft)	24%

According to the definition, Microsoft is not *technically* a monopoly in both 'markets'. However, as Microsoft can be accepted to live within a single market (computing), they would have a clear monopoly. Consequentially, problems of dominance begin to occur. It has been discovered that they have been abusing their market power by forcing small firms into signing contracts that require them to purchase their software, should they be using their hardware.

There are numerous ways to reduce or reclaim the power of monopolies, some controversial, and some are economic theory, therefore unrealistic. I will be discussing these within my essay.

Monopolies tend to play as the dominant firm within their market, and as a result, tend to me price makers rather than takers. However, they can only control the price, or output, but not both. Generally, monopolies can be bad for the market mechanism as they are neither productively nor allocatively efficient. Like most firms, they would choose to profit maximise (at the point MC=MR). As you can see from the diagram on the left, if they choose to output the profit maximising level Q_1, they will receive the price displayed by the demand curve – P_1.

Fortunately, there are several remedies for monopoly. The first that I am going to discuss is: regulation. An excellent remedy for pure monopolies (where a single firm dominates 100% of a market) is regulation. Regulation involves the government appointing an independent body to monitor the activities of the firms.

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Ofcom (merged, previously Oftel) are a working example of this. They are the regulating body for the communications industry, covering telecommunications. Previously, before deregulation occurred, there

were two main dominant firms: *Telewest*/*NTL* (Now *Virgin Medi*a), and *British Telecommunications*. If there was no regulatory body in place, it would have been too easy for this duopoly (where two main firms dominate the market) to price fix (tactically – through the use of informal *signals* to indicate their future and current pricing structures) and therefore take advantage of the consumers, at they would have little choice other than to remove their fixed line telephones completely.

One of the methods that can be used is RPI-X (RPI *minus 'X'*) regulation. The value of X is defined by the regulatory body, and limits the pricing that firms may change based on the RPI (retail price index) *less* the value of 'X'. As a result, if RPI-X<0 then the firms will be forced to reduce their prices by the resultant value. The kind of price barrier will motivate firms to lower costs (as they cannot increase their prices) in order to generate greater profit for themselves. This kind of regulation has been using against British Gas, which expired on the 31st March 2000. Expanding on my telecommunications example: NTL has had agreements put in place by Oftel of RPI-1, so they were permitted to raise prices by no more than the value of RPI, less 1%, per year. However, this particular agreement expired on 31st December 1996.

However, actual regulation has (in my opinion) proven to be inefficient and adequate, and possibly deemed to be failing the industry. A typical example of this lack of regulation is demonstrated by the unstoppable, but inevitable, profits of British Gas. They announced profits of £992 million for the first 6 months of this year, less than 24 hours after raising household prices by 35. This raises the question of whether or not these price rises are justified. They, along with the rest of the market, justify their actions on the elevation of wholesale gas and electricity prices (costs which they cannot absorb), but is this form of a tacit agreement (where firms informally signal price decision to other firms, to suggest they copy)? While it is proven that the barrel of oil did rise to approximately $150 per barrel, the firms were quick to act, raising their prices in quick succession of each other. However, now that the prices have fallen by half, have the firms taken the same quick action in reducing prices? I think not. This is an example of asymmetric information between the firms and the regulator, where the regulator is only dropping suggestions to the firms; they are not forcing any actions upon them. Despite preaches by Fuel Poverty organisations and EnergyWatch (the regulator), prices are still not falling at the rate that they should be. However, one of the most significant problems lie within determining the correct value of 'X' for RPI-X price capping, as the regulator has few resources (as this example has demonstrated), therefore they cannot correctly evaluate costs. Setting a value too low may lead to under investment within the industry, causing undesired adverse effects.

Having said this, the regulatory body has the power to split up a monopoly into multiple, smaller, firms if it deems this as necessary. This can be good for the market, as this will open up it to more competition, and possibly lower barriers to entry for other firms. This is the case of British Gas, where the regulator (*Ofgas*) had split it up into two major firms: Centrica and Transco. The idea was to open the market up to greater competition, as then *British Gas* (a trading name of *Centrica*) who sells the gas to business and domestic users would be separated from *Transco* who manage the actual gas pipelines. This would lower the barriers to entry (*sunk costs*) for new firms, as they would not have to 'produce' the gas, nor have it routed to their customer's homes. They can simply purchase it at a wholesale rate, and sell that on with a margin for profit.

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Other countries have adopted a different method for regulating monopolies, called 'Rate of return' regulation. This is where companies are taxed a percentage of their profits, however this has similar problems. As there is no price ceiling introduced by this method, the monopolistic firm(s) may choose to

simply increase their prices in order to cover the additional tax. This actually solves no problems, and leaves the consumer worse off, as they would be faced with paying higher prices. As the market is dominated by the few single firms, it may leave the consumer no choice but to purchase their goods from those single or sole suppliers at the higher cost.

The competition commission also has a strong say on mergers, whether or not they are permitted to go ahead, if there is a threat to the market of a monopoly. An example of this was the *Halifax Bank of Scotland* and *Lloyds TSB* merger which resulted in a monopoly for the merged company of the mortgage market – over 30% market share. However, these rules were “brushed” aside due to the nature of the merger, and the apparent confidence that the bank would collapse, and the government being unable to use more public money, therefore being unable to resort to nationalisation without public backlash.

The reverse of regulation, de-regulation, can also help to remedy the problems of monopoly. De-regulation is when remove or simplify restrictions on a market in order to increase competition, or the threat within. While the thread of competition may keep push prices down (limit pricing – where firms sell at just above their average costs, therefore diminishing the threat of new firms entering the market, forcing any new entrants not to take the chance as the barriers to entry and exit may be too high), it may not been enough in the long term. An example of this is the postal industry. In 2006, the market was fully deregulated, meaning that any new entrant had the ability to complete a range of functions, ranging from collecting and deliver door-to-door mail, to bulk mailing. While this does open the market up to some serious competition, the barriers to entry are still too high. The initial cost of dropping door-to-door mail to 99% of the country is very labour intensive, and explains why the state owned Royal Mail have a monopoly on this. Additionally, there needs to be a way for new firms to pick-up the mail locally from their clients. All this has to be profitably fairly quickly, as if they firm does not have enough finance behind them, they will quickly go bankrupt. However, there have been several new entrants to the marketplace for courier services, and this has become more apparent over the past few years. Such an example is www.Parcel2Go.com (who are a reseller of such companies such as DHL), but pickup large items from your home (as this cheaper service is domestic) and deliver it to another place of a domestic nature for a extraordinary low fee – in comparison to the pricing that Royal Mail would change for the same service.

Monopolies can also be dealt with by challenge of new firms. However, when a monopoly exists, this is sometimes less likely due to barriers to entry and exit. The new entrants have to assess these barriers, and judge whether or not it would be wise for them to compete; this then encompasses the theory of contestable markets. There are several factors involved, such as the reputation (pricing predictions) of the current (incumbent) firm.

The existing monopoly may employ (legal) limit pricing to keep the threat of competition low, or apply predatory pricing. Illegal in the UK, predatory pricing involves setting the price below cost, with the intent to drive out their rivals, and then raise prices again. Another such formal form of collusion is cartels, however they are also forbidden by law. Fortunately, such anti-competitive practices are removable, however unfortunately, as I have discussed above: tacit collusion is the most likely and the hardest to prove -

and stop. Furthermore, there is resale price maintenance where the manufacturer will fix the price that the retailer must sell their goods at (they will generally apply this), and if they did not they would refuse to supply, which is again, illegal.

Additionally, the incumbent firm can compete with non-pricing strategies, such as brand loyalty schemes or certain kinds of special offers so that their customers naturally do not buy from their competitors. There are also considerable sunk costs that are involved, and the more irrevocable they are, the less tempting for the new entrant. Depreciation is common, and when technology is fast-moving, a production system that's 6 months old can lose considerable value, quickly.

An almost totally irrevocable cost is advertising – such as branding and gaining that brand awareness and loyalty. While its average cost can be kept low by spreading the budget over large volumes of output, however the only realistic way this cost can be recovered, is if the firm was to sell their entire brand to the monopolist. Unfortunately, the incumbent firm can easy rival any advertising that the new entrant makes, making their efforts redundant.

There may also be legal barriers, but these are more uncommon than not. Such barriers will include Patents, where the incumbent firm is rewarded for the research and inventions that they have created, so have a legal barrier to prevent any other firms from coping their idea, design or otherwise. Such patents stand for around 2 decades, so this can be a considerable amount of time for the incumbent firm to gain a monopoly on their product (regardless of the fact they will be the sole supplier).

Natural monopolies act at as a barrier to entry for new firms, and within industries such as Water (*Thames Water* have a monopoly on this), it would be too costly and inefficient to lay down two pipes to consumers homes'. However, should the market be deregulated – for example, if Thames Water sell the water a wholesale price (such as British Gas does with Gas) then additional firms can afford to enter the market with lower barriers to entry. Finally, there is information asymmetry, where the existing firm has the experience and the knowledge about the industry that allows them to be more productive and drive down their costs. If the information is not known to the new entrants, this can be a sunk cost for them, acting as yet another deterrent for entering the market.

However, having discussed the problems that monopolies may bring, the reverse can be true. Monopolies can be beneficial to a market because they achieve greater economies of scale, and tend to have a lower market price than smaller firms – as they are more able to pass on cost reduction. A typical example of this would be the comparison of a monopolistic firm such as *Tesco* against *Jay's News*. A typical product, one pint of milk will cost around 49 pence in a small firms shop, or 26 pence in *Tesco*. At a 53% saving, it seems clear that monopolies can benefit the greater economy.

Sources:

NTL Price Capping: http://www.ofcom.org.uk/static/archive/oftel/ind_info/broadcasting/ntlprice/section2.htm