



C O M P A L P R O G R A M M E

Projects for Bolivia, Costa Rica, El Salvador, Nicaragua, and Peru

Brainstorming: How to improve the impact of the COMPAL sectoral studies A diagnosis and suggestions after one and a half years¹

Geneva, 22 September 2006

A. DIAGNOSIS

I. Introduction

1. In August 2006, an initial revision of the guidelines “Practical Guidelines for evaluating the potential anti-competitive impact of corporate practices in selected markets of COMPAL programme countries” (April, 2005) was initiated.
2. This revision was launched as very few of the sectoral studies completed in 2005 were able to identify potential anti-competitive practices and did not conform to the expectations of the Programme Management Committee (hereinafter PMC, which is composed by UNCTAD and national coordinators). Despite efforts from the PMC and national consultants to design alternative methods to find data on the selected market or sector, many of the studies presented serious methodological flaws and lacked adequate data.² As such, the following three types of problems were identified: technical skills, institutional framework, and structural.

a. Methodology: Technical skills

- Use of unusual methodologies as the selected consultants proved to not have previous expertise in the field as expected
- Incorrect usage of appropriate methodology (due to inexperience)

b. Data: Institutional Framework Problems

- Problems related to the inexistence of data, it was too difficult to obtain, the consultants did not know where to find it, or pure disregard of its importance

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² The General Assistant to the PMC delivered a presentation on the lessons learnt as regards the implementation of the sectoral studies during 2005. This was carried out on the occasion of the Seminar held in Lima, Peru (February 2006).

c. Structural Problems

In addition to data and methodological issues, many of the consultants did not follow the TOR's and guidelines and thus presented incomplete studies. In some cases the studies were inconsistent with the TOR's due to different national circumstances the consultants faced when preparing them³.

The following are some of the preliminary results:

- Studies that were too specific
- Studies that were too broad (Hydrocarbons)
- Studies that left out sections (either lack of data, lack of experience,) i.e. example of the Health services in Peru by Abel Rodriguez - activity P.1.1.
- Studies whose contents were difficult to understand
- Studies that did not calculate the impact of the anti-competitive practices

3. Therefore, in order to attempt to correct some of these problems and ensure that future studies would be more rigorous, it was suggested that the guidelines should be revised in order to⁴:

- Remind the consultant of the relevant theory and appropriate methodology to be employed as regards the economics of competition
- Provide a list of suggested data sources, though not comprehensive
- Present a more specific suggested outline for the study in order to ensure better results.

4. Although the revision of the guidelines is one possible solution to address the quality of the sectoral studies, over the course of this exercise it became apparent that an alternative solution would be to revise the activity itself. As such, this document contains suggestions as to how the activity could be modified to better fit the immediate needs of the recipient countries. In what follows, we argue theoretically and pragmatically the feasibility, the appropriate time frame and envisaged results of implementing sectoral studies in the field.

II. Reasons as to why sectoral studies may not be the best type of technical assistance for COMPAL beneficiary countries at this point in time

a. Recent research on what types of technical assistance are most effective, and under what conditions

5. There are diverse opinions as to the effectiveness of different types of technical assistance (hereafter TA). Although a study by UNCTAD suggests there is no general agreement that one type of TA is more effective than another, and that the type of TA used should be based on a needs assessment (UNCTAD 2004, p.1) several other studies propose that some forms of TA might be more important than others.

6. While these studies and reports do not deny the importance of a needs assessment, much of what has been written on evaluating the effectiveness of TA also highlights that the level of

³ In the market study on used clothing (Prenderia usada, Bolivia), the consultant found that the main problem in the used clothing sector was the informal businessmen as they were hampering the competitiveness of the formal micro-enterprises.

⁴ The completed version of the revised version of the Guidelines are attached in this proposal -- see Annex I

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social and economic development, the extent of competition culture as well as some agency characteristics have a significant impact on the effectiveness of different types of assistance.

7. In particular, two empirical papers have recently been written on assessing the effectiveness of TA. In his paper on the effectiveness of TA, *Evenett* finds that “not all forms of technical assistance are alike in their effects and the impact on recipient authority performance appears to vary systematically with absorptive capacity and socio-economic development”(Evenett 2006, p.1). Moreover, *Nicholson et al* find “a strong and robust finding that TA characteristics, recipient agency variables, and country level variables are all working to determine the perceived effectiveness of technical assistance” (Nicholson 2006 p.21)
8. In addition, *Evenett* finds that competition agencies with a limited capacity to absorb⁵ TA benefit more from the presence of short-term advisors or consultants, attending national, regional and international workshops, and from procurement than they do from long-term advisors and study missions and internships abroad. An interesting note related to the topic at hand, *Evenett* finds that commissioned academic studies add little to recipient agency performance (Evenett, 2006, p.7).
9. As the empirical work on TA effectiveness is very new and much work is still to be done, some may not be convinced by these results. However, first-hand accounts provided by donors and recipient agencies also highlight their preference or need for certain types of assistance over others. In a study carried out by the Organization for Economic Cooperation and Development (OECD), it is reported that the types of programmes that receive the most attention by beneficiaries are: conferences, seminars, internships and long-term advisors (OECD 2002, p.8). It is also noted that recipient countries largest expressed needs relate specifically to competition authorities’ law enforcement work. In particular, the dominant theme seems to be TA should be practical assistance relating to day-to-day issues, building technical capacity. One element is through staff training, specifically investigation techniques (OECD 2002, p.7-8) Furthermore, in their 2005 report on assessing TA for competition policy, the International Competition Network (ICN) found that their survey data underscores the value to recipients of improving training programs and materials (ICN 2005, p.48).
10. Although the results of recent research do provide general conclusion that may assist in an assessment of different types of assistance, such as the importance of considering the socio-economic development of a country and the capacity of an agency to absorb⁶ assistance when designing a TA project, the specific results on the effectiveness of types of TA may vary from one source to the other. Thus, one should be cautious in assessing the value of one type of TA over another. As such, a case-by-case approach might be the most appropriate methodology to determine which type of assistance is most appropriate.

⁵ Evenett defines Absorptive capacity as a composite measure based on whether the competition authority is an independent body, it was established and began at least 5 years ago, the average tenure of the heads of the competition authority is at least three years, the number of professional lawyers and economists employed by the competition authority equals or exceeds 10.

⁶ It is important to note that this reference to capacity to absorb refers to the general concept, and not necessarily the specific composite measure as defined in Evenett’s paper.

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b. General concepts for evaluation and monitoring the results of the sectoral studies in COMPAL recipient countries

11. Many agencies use the following five categories⁷ when evaluating and monitoring the results of a TA programme:

- **Relevance:** the legitimacy of the overall goal and the project purpose in connection with recipient countries wants and needs
- **Effectiveness:** the extent to which the project purpose has been achieved as a result of the outputs of the project.
- **Efficiency:** the productivity of the implementation process (i.e. to what extent the inputs and activities have been converted into the outputs)
- **Impact:** direct/indirect positive/negative effects that have been or will be caused by the project
- **Sustainability:** the extent to which the benefits generated by the programme can be sustained

12. With respect to the recipient countries, it is suggested that the sectoral studies, in their present form, do not adequately fulfil these criteria. For a more specific assessment it is suggested that the national coordinators, as direct beneficiaries, should complete the following chart.

Table No. 1: Assessment of the six studies carried out in 2005

Studies / criteria	Relevance	Effectiveness	Efficiency	Impact	Sustainability
Cooking oil (NIC)					
Transport (ES)					
Used clothing (BO)					
Health services enterprises (PE)					
Hydrocarbons (PE)					
Financial services (PE)					

However, a preliminary and general assessment has shown the following:

- **Relevance:** Given the institutional framework, level of competition culture and absorptive capacity of the agencies (either competition authority or other type of regulators) it appears that the sectoral studies are not the most relevant type of assistance programme.
- **Effectiveness:** The studies have had a low level of effectiveness as they have not been able to identify anti-competitive practices in sectors where it is believed they exist.
- **Efficiency:** The sectoral studies seem to have not been a productive use of resources, given the low level of effectiveness
- **Impact:** at the present time, the impact of the sectoral studies is perceived to be low.

⁷ As proposed in 1991 by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD)

- Sustainability: Given the problems faced in the previous studies, it is projected that it is unlikely that future studies will be more successful unless significant progress is made on data availability and knowledge of the methodology.

B. SUGGESTIONS

13. Given the previous discussion on the effectiveness of sectoral studies, the evaluation of COMPAL studies and why they may be not be appropriate for certain COMPAL countries at this point in time, considering their capacity to absorb assistance, level of competition culture and institutional framework it is suggested that COMPAL should consider a two pronged approach to redistributing efforts to *developing the institutional framework and technical skills⁸ to carry out sectoral studies in these countries*. This two pronged approach of addressing 1- technical skills and 2 - institutional issues, has been suggested as a way to address the problems encountered in the sectoral studies, as identified in section 1 of the diagnosis.
14. In addition, a second suggestion will build on the idea of having studies under the COMPAL framework. This first point of departure for this suggestion relies on the national reports on competition carried out during phase 1 of the programme. At this point COMPAL considers it important to define of the types of reports that COMPAL has commissioned and that it envisages doing in the future (as they will be referenced below).
- **National Report on Competition/Consumer Protection**: The objective of this report is to provide the overall economic context, institutional and legal framework, international cooperation, and problems identified. (As completed in Phase 1 of the COMPAL programme)
 - **Report on the potential existence of anti-competitive behaviour at national level**: This report would be a general investigation on an aggregated level of business practices. In particular, the focus could be on industries that traditionally harbour anti-competitive practices, such as industries with many trade associations, state-owned enterprises that have been recently privatised (and for example, state marketing boards). The ultimate goal of this report would be to clearly identify sectors/markets in which potential anti-competitive practices may exist. This report will be useful for competition authorities or offices in charge of competition in the beneficiary countries.
 - **Sectoral Study**: analysis of a particular sector (structural approach) in accordance with the steps followed in the economic analysis of competition. This includes (as put forth in the guidelines of April 2005): Determining the relevant product and geographic market, measuring the market shares and market power, identification of possible anti-competitive practices in accordance with the competition law, and measurement of the impact of the identified anti-competitive practice.
 - **Market study**: report on a particular market that has been identified within a sector. (Disaggregated). In the specific market segment, the study should look at anti-competitive practices using the same methodology as the above study.

⁸Please Note: This technical skill building includes working with all actors involved in the creation and implementation of a competition regime

15. It is worth noting that these two set of suggestions are complementary because of the integral approach that it is being considered in accordance to the overall and ongoing implementation of COMPAL activities. In the following paragraphs, the two set of suggestions are described in detailed.

I. Suggestion as regards the redistribution of efforts to institution and technical skill building activities:

16. It is often suggested that the types of programmes that are most appropriate when a country does not have a competition law or recently established competition authority are those that help to build a competition culture. In addition, as highlighted above, in general and in countries with no competition law, activities that help to develop the necessary technical skills are the most appropriate, and requested by recipient countries. Therefore, one possible alternative to commissioning sectoral studies is for COMPAL to devote resources to developing the skills to carry out sectoral studies in the recipient countries.

17. The following activities are suggestions of technical skill building activities (thus addressing the first problem, that of skill deficiencies)

a. University course with the ongoing COMPAL programme:

18. Under the COMPAL programme, university programmes have been established in Bolivia (B.1.4.), Costa Rica (CR.1.4. & 2.4. and Nicaragua (N.1.1.4). We suggest that resources should be devoted to extending and strengthening these activities, as well as initiating something similar in El Salvador. (For Peru see below)

19. These ongoing university programmes (Nicaragua started on 18 September 2006!) containing curriculum for a course on competition law and policy should be extended to include a module on how to carry out a sectoral study in situations where a regulatory authority that is monitoring the sector or market does not necessarily exist. The curriculum should be designed to first teach students how to search for allegations of anti-competitive practices that violate the competition law or draft law, and then build a case. As part of the coursework (perhaps final project) the students should be asked to complete a sectoral study on the sector of their choice (or from a list of sectors selected by the PMC) in their country.

20. Upon completion of the course, all sectoral studies, as well as the research on allegation of anti-competitive practices would be submitted to the PMC. Though there is no guarantee as to the quality of these studies and research, it is possible that a few may provide valuable information and could then be used by the PMC.

21. This activity would have a possible impact on developing the capacity to conduct sectoral studies. In addition, it is important to note the secondary impact, that of generating information on different sectors for potential institution or sectoral regulators.

b. Short term training programme/seminar

22. A training programme could be designed, open to participants from government, academia, and private sector (consultants) that would teach participants the importance of a sector and

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study and how to complete one. This training programme could be regional and thus open to all participant countries, but it would be most effective if it was country specific as this would allow the instructor(s) to address the precise problems present in each country. In either case, materials could be developed to teach what data is important, to teach how and where to find the data, the methodology to employ etc. It is suggested that the instructors for these training programmes should be ex heads of competition authorities from the Latin American region, as they have experience dealing with the types of problems these countries face.

c. Training materials

23. Creation of a publication on how to conduct a sectoral study, tailored to meet the needs of countries with weak competition culture. A starting point for this idea can be the revised version of the guidelines annexed to this document.

The last suggestion addresses the second problem identified above, the institutional aspect.

d. Strengthening of national data collection agencies

24. Given the fact that a major impediment to the completion of many sectoral studies commissioned by COMPAL was the lack of available data, it is suggested that resources be devoted to strengthening the relevant national data collection agencies. As such, through the national coordinators it may be possible to work with the data collection agencies. Possible activities could be sensitizing and training seminars with the heads of these institutions.

II. Suggestion to continue with other types of reports

25. The following solution does not directly address the institutional and capacity issues, instead it is a suggestion as to how the COMPAL programme could continue to pursue a different type of commissioned study in order to take into account the difficulties consultants face in participant countries.

a. Creation of new type of report: Allegations of anti-competitive practices report

26. Though the sectoral studies were unable to provide evidence of possible anti-competitive practices, some of them did provide valuable and interesting information on the sector. As such, in countries that lack competition authorities and an established competition culture, or where data is difficult to find, it may be appropriate to hire international consultants⁹ to write a national report on potential anti-competitive behaviour (As described in paragraph 16 above). This could involve a review of media and interviews with industry participants, among other things.

III. Proposal for Peru and Costa Rica

27. As Peru and Costa Rica have long-standing experience in terms of the work of their competition authorities and do not face the same type of skill restraints and data collection

⁹ The former proposal on the feasibility of implementing an advisory committee to review the sectoral studies included the participation of former heads of competition authorities in the Latin American region. In this regard, it is suggested that the individuals contacted under this proposal will be considered as first options for the consultancy work (as also suggested in paragraph 23)

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difficulties that the other three countries face, it is suggested that sectoral studies may still be an important activity. However, a more meticulous selection of consultants is necessary as well as more specific TOR's and guidelines.

C. CONCLUSION

28. In this document we have identified the main problems that have prevented consultants from generating high-quality sectoral in-depth studies. In turn, after a discussion on assessing the effectiveness of the sectoral studies, we have proposed a two-pronged approach (technical skill (paragraph 3a) and institutional building (paragraph 3b) to increasing the impact of the sectoral study. In addition, we have proposed an additional suggestion to the two-pronged approach that would allow COMPAL to continue with a different type of sector report.
29. It is important to note that the suggestion to redistribute efforts to developing the institutional framework and technical skills to carry out sectoral studies is most relevant in those countries that face difficulties in developing their capacity and institutions to facilitate them. As such, the suggestions may not be as appropriate for Peru and Costa Rica, to some extent.

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References:

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- Evenett, S. (2006) "The effectiveness of technical assistance, socio-economic development, and the absorptive capacity of competition authorities" ICN Cape Town Conference
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- ICN (2005) Assessing Technical Assistance for Competition Policy: Preliminary Results, International Competition Network

Annex

Revised practical guidelines for establishing the possible existence of anti-competitive practices in selected markets of COMPAL programme countries



COMPAL PROGRAMME

Projects for Bolivia, Costa Rica, El Salvador, Nicaragua and Peru

Revised practical guidelines for establishing the possible existence of anti-competitive practices in selected markets of COMPAL programme countries¹⁰

Geneva, September 2006

(...)

III. Suggested structure and guidelines

Based on the aforementioned recommendations, and with a view to maximize the benefits derived from the COMPAL studies, it is suggested that all commissioned studies contain the following sections.

- I. **Executive Summary (in Spanish and recommended, in English).**
- II. **Index**
- III. **Introduction (including motivation and objective of market study)**

a. Introduction to the sector and economic context

b. Motivation for an investigation in this sector

This section must indicate and expound why the relevant sector has been selected for a sector study. This information shall first be provided by the national coordinator and secondly, be developed by the consultant. As such, in order for a sector to be approved as the subject of a sector study, COMPAL must receive answers to the following questions (also attached as a questionnaire, see Annex 2) from the national coordinator. These questions will provide the motivation for the study as they ask the national coordinator to identify the reason(s) why the particular sector is thought to contain anticompetitive practices and thus has been selected as a subject for study. Without this information, it will be impossible to initiate a sector study. These questions provide crucial background information that is necessary for the consultant to complete the study, as they provide a context for the study and starting point from which the investigation can begin.

After the national coordinator has submitted answers to these questions, it will be up to the consultant to elaborate and obtain additional details and/or clarification. However, as stated above, it is necessary that the consultant has the answers to these questions prior to initiating a study. With this information from the national coordinator, the consultant should be able to provide more compelling and insightful analysis and conclusions.

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Proposed questions to be given to the national coordinator

1. Please indicate whether the following factors had any role in the selection of the sector for a sector study for the COMPAL programme. Please indicate whether they are: "not relevant", "somewhat important", "important", "very important".

- a. Reliable information on the existence of monopolistic practices, cartels, or other anti-competitive practices (please specify)
- b. Significant increases in prices (in real terms)
- c. High economic concentration
- d. Low economic performance compared to similar countries.
- e. Complaints made by competitors (please specify, if possible)
- f. Complaints made by producers (please specify, if possible)
- g. Complaints made by consumers (please specify, if possible)
- h. Complaints made by other sectors (please specify which sectors)
- i. Complaints made by government officials (please specify)
- j. Results from investigations by non-governmental organizations (please specify)
- k. Information/investigations from/by the media (newspapers, radio, television, internet)
- l. Information from experts or academic institutions (please specify)
- m. Other (please specify)

2. With respect to the "important" and "very important" factors, please explain the motivation of the investigation.

3. Please indicate if there are other sectors you believe should be the subject of a sector study. Please name the sectors and why they have been chosen.

4. Please indicate whether it is "unlikely", "probable", or "very probable" that the following results will be found through the investigation.

- a. Concrete evidence of a firm's abuse of their dominant position
- b. Concrete evidence of exclusion, or harm to their competitors
- c. Concrete evidence of a cartel
- d. The existence of barriers to entry or other distortions to competition that would be possible to remove through government action (regulatory or deregulatory)
- e. Others (please specify)

5. Please include any other information that you believe is relevant and explains why this particular sector has been suggested for a sector study.

IV. Definition of the terminology used in the study

IV. List of abbreviations used in the study

V. Core Text

It is expected that the core text will contain the following elements. Following each heading is a brief description of the necessary information to be included and the methodologies that can be employed. **Please see Annex 3 for suggestions on data sources.**

a. Full description of economic sector, industry and products as well as regulatory law for the market under study

i. Description of the institutional framework

The section must include a description of the institutional framework, including:

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- Legal and regulatory framework
- Producing firms (number, type, production capabilities etc.)
- Technology employed and a description of the production process
- Mechanisms for wholesale and retail distribution,
- Sales volumes,
- Concentration in the industry or along the value chain
- Patterns of consumption and other characteristics of demand,

ii. Analysis of prices

The section must also provide an analysis of prices. It should include:

- Price formation,
- Evolution of prices over time
- Differentiation or discrimination mechanisms,
- Margins

b. The relevant market (geographic and product)

i. Introduction: Importance of the relevant market

Market definition plays a key role in competition analysis, as it allows one to determine the scope, both geographically and in terms of goods/services, within which to examine the possible existence of anti-competitive practices. In general the more narrowly the market is defined the more likely a firm or firms will be found to have market power. Not surprisingly, firms tend to advocate for wider market definitions than those adopted by competition authorities.

It is important to recognise that the definition of the relevant market constitutes only a preliminary step in the assessment of the existence of possible anti-competitive practices. The definition of the relevant market is used to calculate market shares and indices of market concentration based upon those market shares, (these will be defined in the following sections).

ii. Definition of the relevant market

The relevant market within which to assess competition issues is established by the combination of the product and geographic relevant markets.

1. Product relevant market

The relevant product market, as defined by the European Commission, "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."¹¹

2. Geographic relevant market

The relevant geographic market, as defined by the European Commission, "comprises the area in which the firms concerned are involved in the supply of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas".

iii. Identifying competitive constraints

¹¹ The European Commission's definitions of the Product and Geographic market are commonly quoted. The definitions are taken from the Commission notice on the definition of relevant market for the purposes of Community competition law Official Journal C 372 of 09.12.1997

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The competitive constraints of a market must first be identified in order to define the relevant market. Firms are subject to three main sources of competitive constraints: demand substitutability, supply substitutability and potential competition. Demand substitutability and supply substitutability will be discussed here, and potential competition will be addressed in the market power section.

1. Demand Substitutability

a. Quantitative and qualitative criteria to identify the relevant market

In practice, the definition of the relevant product and geographic market generally focuses on demand-side substitutability as demand substitution constitutes the most immediate and effective disciplinary force on the suppliers of a given product, in particular with respect to their pricing. A firm or a group of firms cannot significantly influence the prevailing conditions of sale, such as prices, if its customers can easily switch to substitute products or to suppliers located elsewhere. Consequently, the definition of a market consists in identifying the effective alternative sources of supply for the customers of the firms involved, both in terms of products/services and geographic location of suppliers.

A combination of quantitative and qualitative criteria can be used to assist in identifying the products that belong to the relevant markets. Substitutes can be determined by considering:

Physical and technical characteristics: In general, if a buyers places a high value of on the actual or perceived unique physical or technical characteristics of a product, then it is likely that the product will be found to be in a distinct relevant market.

End use: Functional interchangeability is generally a necessary, but not a sufficient, condition that must be met for two products to be included in the same relevant market.

The preferences, perception and behaviour of buyers: Whether buyers have substituted between products in the past can indicate whether they belong in the same market.

Trade views, strategies and behaviour: Third parties who know the industry in question may provide helpful information regarding past and likely future developments that help to define the relevant market.

Switching costs: The transaction costs (both for individual consumers and intermediate buyers) may be sufficient to make switching between products unlikely. These costs for wholesalers may be: costs incurred to repackage, adapt marketing, breach a supply contract, and learn new procedures.

Price relationships and relative price levels: If no strong correlation in price movements between two products (or geographic areas) over a significant period of time is found, this generally suggests that the products are not in the same relevant market. On the other hand, if the prices of one firm have constrained the price movements of another in the past, this is an indication that the two firms' products compete in the same market.

Transportation costs: In general, when prices have been higher in a distinct area than prices in the relevant geographic area by an amount greater than the transportation costs, this is usually an indication that the other area does not belong to the relevant geographic market.

Shipment patterns: Significant shipments from one region to another generally suggest that the two regions are in the same geographic market. However, past trading patterns can be a poor indicator of the extent to which sellers in one area constrain sellers in another area, particularly where there is an absence of shipping.

Foreign competition: While the above-noted principles apply equally to domestic and international sources of competition, there may be other considerations when examining the influence of foreign-based suppliers. These include tariffs, quotas, regulations, antidumping complaints or duties, government procurement policies, intellectual property laws, exchange rate fluctuations, and international product standardization.

Entry barriers: see the discussion below under market power (pg. 20)

b. The SSNIP test: Accepted standard in merger guidelines

As for concrete, quantitative tests, the SSNIP¹² test (also commonly referred to as the 'hypothetical monopolist test) has been widely accepted as the appropriate tool used to define a relevant market. Though the test may not be precise, it is often the most useful way to probe the boundaries of the product and geographic markets.

The SSNIP test is an iterative process that seeks to identify the smallest market (thus relevant market) within which a hypothetical monopolist or cartel could profitably impose a small but significant, non-transitory increase in prices. Beginning with the narrowest possible product definition (or geographic area) the test asks whether a monopolist or cartel could profitably sustain a price increase of x%¹³ (5% is most common) for at least one year on a *ceteris paribus* assumption that the terms of sale of all other products are held constant. If a sufficient numbers of consumers are likely to switch to alternative products as to make the price increase unprofitable, then the firm or cartel lacks the power to raise price. The relevant market therefore needs to be expanded. The next closest substitute is added and the process is repeated until the point is reached where a hypothetical cartel or monopolist could profitably impose a 5% price increase. The range of products or the geographic area so defined constitutes the relevant market.

How to apply the SSNIP Test:

- Start with smallest possible market and ask if x% price increase would be profitable
- If not, then firm does not have sufficient market power to profitably raise prices. Relevant market not defined.
- Next closest substitute is added to the relevant market and test repeated.
- Process continues until the point is reached where a hypothetical monopolist could profitably impose a 5% price increase.
- Market is then defined (product or geographic market)

c. The cellophane fallacy

In defining both product and geographic one must assess the extent to which prices would likely be lower than prices that would prevail in the absence anti-competitive acts. This means that sometimes, the current price may not be the appropriate tool to use in defining the relevant market in which a firm competes. If there are anti-competitive practices in place, it is possible that some products that appear to be in the market would not be included in the market at price levels that would have existed in the absence of the anti-competitive practices. From an antitrust perspective, to include these products in a market definition would effectively overstate the product market. This occurs because these products do not discipline the market but rather enter the market only at price levels that are

¹² The term SSNIP test comes from the wording of the formulation of the test in the US Guidelines.

¹³ Though the value may vary across jurisdiction and none of the merger guidelines acknowledge the existence of a single correct percentage, a 5% price increase is the standard and most popular benchmark for the SSNIP test. However, it may be true that a higher, or lower percent is appropriate. For example, the EC merger guidelines refers to a 5-10% range whereas Brazil to a 5, 10 or 15% range depending on the circumstances. In addition, the Canadian, U.K (CC) Guidelines and U.S. Guidelines indicate that a larger or smaller price increase may be used where the application of a 5% increase would not reflect market realities.

higher than normal competitive levels. A similar situation occurs in defining the geographic scope of the market. If the market is defined in terms of price levels reflecting a dominant player, the geographic scope of the market will be overstated, as they will include areas that could not be included if competitive price levels prevailed¹⁴.

The right way to avoid the cellophane fallacy depends on the type of anti-competitive practice one is concerned with.

In a merger case, one is typically concerned with whether the merger enhances the firm's market position in a way which could be abused. The correct question is then whether the firms involved in the merger are likely to be able raise prices as a result of the merger and earn higher profits. To answer this question, one may apply the SSNIP test to existing market prices. That is, to ask whether, as a consequence of the merger, an x% increase in prices above the current level can be sustained by the merged firm. If so, the merger will clearly enhance the firm's market power; if not, then the market that the merged firms operate in must include other products, areas and/or suppliers, and its competitiveness must be assessed when its exact boundaries have been ascertained

In a so-called monopoly inquiry, where one is exploring whether one or more firms have, or have abused, a monopoly position, it is unwise to use prevailing market prices as the basis from which to consider a hypothetical x% price rise since there is at least a chance that those prices will already reflect an element of monopoly power. A better procedure is to start by determining what level of prices might prevail if the market were competitive, and then use that as the basis of the SSNIP test. If prevailing prices appeared to be sustainable and were x% or more higher than this level, then it would follow almost immediately that the firm(s) in question had at least some market power.

2. Supply Substitutability

Supply-side substitutability may also be taken into account when defining markets. Supply substitution is relevant in situations where the effects are equivalent to those of demand substitution in terms of effectiveness and immediacy. Supply substitutability requires that suppliers are able to switch production to the relevant products and market them in the short term without incurring significant additional costs or risks in response to small and permanent changes in relative prices. When these conditions are met, the additional production that is put on the market will have a disciplinary effect on the competitive behaviour of the companies involved.

c. Assessing market power and competition through an analysis of market structure, participation shares and concentration

i. What is market structure and why is it important?

Market structure refers to the number, relative size and distribution of firms in a market. The market structure is often quantified by two related indicators, market shares of participant firms and market concentration indices. (See below for definition)

The importance of market structure (and thus market shares and concentration indices) in competition analysis is partially derived from the traditional (see alternative below) view that it is the structure of a market that determines the conduct of the firms within that market, and in turn, this determines the nature of the market outcomes that will be observed. This relationship is developed by the SCP (structure-conduct-performance) paradigm¹⁵. This theory propounds there is a causal

¹⁴ This problem of measuring markets where it is alleged that dominance prevails, was first identified in the context of a famous US anti-trust case against cellophane producer, Du Pont in 1956. As a result, it is referred to as the "cellophane fallacy." Du Pont argued that cellophane was not in itself a separate market, since at prevailing prices there appeared to be a high cross elasticity of demand between cellophane and aluminium foil, wax paper and polyethylene. This meant that what seemed to be a near monopoly of "the cellophane market" was more likely a modest share of a market that could be called "the wrappings market".

¹⁵ The SCP paradigm was the dominant paradigm in industrial organization from 1950 till the 1970s. The framework is based on the seminal work by Mason and Bain.

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relationship between structure, conduct and performance. It posits that structure influences conduct and both structure and conduct influence performance. Therefore, though market outcomes (such as the level of prices) are the primary concern of competition authorities, market structure is seen as an important indicator of the likely nature of those outcomes.

Structure-Conduct-Performance Paradigm

Structure: refers to market structure defined mainly by the concentration of market shares in the market.

Conduct: behavior of firms - competitive or collusive (pricing, R&D, advertising, production, choice of technology, entry barriers, predation...)

Performance: efficiency, mainly defined by extent of market power where greater power leads to lower efficiency)

Efficiency Hypothesis

Reverse causal relationship

Performance determines structure

The Efficiency structure hypothesis and the Simultaneity problem

However, it is important to note that the SCP paradigm ignores the possibility of reverse causal links in the relation between structure, conduct and performance. In the SCP hypothesis, there is a positive relation between concentration and performance (efficiency), however the efficiency hypothesis, developed in the 1970's, suggests that there is a negative relation between the two. This alternative theory suggests that it is the level of efficiency that determines the market structure. The critical difference between the two is that in the SCP the market structure is assumed to be exogenous and performance, endogenous. However, the reverse is also possible, as argued by those who suggest that it is performance (efficiency) that determines structure (market share). In practice, as posited by the simultaneity problem, it is likely that both the direct and reverse effect of the SCP paradigm are important,

As such, it is important to remember that a concentrated market does not necessarily imply that the market harbours anti-competitive practices and is inefficient. Market structure may determine the market performance, but the reverse may also be true.

ii. Market shares: How to calculate

The definition of the relevant product and geographic market allows for the identification of the **market participants**, the suppliers and the consumers active on that market. In turn, each suppliers total **market size** and **market shares** can be calculated on the basis of their sales of the relevant products on the relevant area. In practice, the total market size and market shares are already available from market sources, i.e. companies' annual reports, studies commissioned to industry consultants and/or trade associations.

Market shares are important in the analysis of potential anti-competitive practices for if firms belonging to the market all have low market shares (that is, each serves a relatively small segment of the market) there is little or no chance that any will have market power. If however one or more firms

See Mason, Edward S. "Price and Production Policies of Large Scale Enterprise" *American Economic Review* 29 (1939): 61-79

Mason, Edward S. "The Current State of the Monopoly Problem in the United States" *Harvard Law Review* 62 (1949): 1265-1285

Bain, Joe S. *Barriers to New Competition*. Cambridge, MA: Harvard University Press, 1956

Bain, Joe S. *Industrial Organization*. New York: John Wiley & Sons, 1959

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have a higher market share, there will be a greater risk that these firms have at least some market power and competition may therefore be weaker.

Although sales are usually the indicator used to calculate market shares, there are nevertheless other indicators that, depending on the specific products or industry in question, can offer useful information. Examples would be: capacity, the number of players in bidding markets, units of fleet (as in aerospace), or the reserves held in the case of sectors such as mining.

iii. Market Concentration: How to calculate (using market shares)

Market concentration is a function of the number of firms in a market and their respective market shares. As an economic tool, market concentration is useful because it reflects the degree of competition in the market. There are various methods used to measure concentration, each will be discussed below.

1. Coefficient C_m : m-firm concentration ratio

The m-firm concentration ratio (C_m) is calculated based on the market shares of the largest m firms in the sector. The most commonly used is the C_4 , which is simply the sum of the market shares of the *four* largest firms in the market in question. For example,

$$C_4 = \sum_{i=1}^4 s_i$$

The value of the C_m varies between 0 (minimum concentration) and 1 (maximum concentration). However, it is important to note that the C_4 only provides limited information about actual market structure. For example, in a market where the largest four firms each had a market share of 20 % , the C_4 would be .8 (80%). On the other hand, a market in which one firm had a market share of 50% and the other three firms with 10% each would have the same C_4 . Yet, a firm's behavior may differ greatly in these two situations and thus create different competitive outcomes.

2. Herfindahl-Hirschman Index ("HHI")

An alternative measure of market concentration is the Herfindahl index (HHI). The HHI is calculated by summing the squares of the individual market shares of all the participants. Unlike the four-firm concentration ratio, the HHI reflects both the distribution of the market shares of the top four firms and the composition of the market outside the top four firms. It also gives proportionately greater weight to the market shares of the larger firms, in accord with their relative importance in competitive interactions. However, it is more difficult to compute as it requires knowledge of the market shares of all firms in the industry.

This index is defined as follows:

$$H = \sum_{i=1}^N s_i^2$$

where the summation is over all N participants in the market and s refers to the market share of each. The share can be expressed in per unit (in which case the maximum value of H is 1) or more commonly, in percent (in which case the maximum value of H is 10000). A larger value of H indicates greater market concentration (and therefore the potential for greater market power) than a smaller value.

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The thresholds for different level of concentration vary from country to country. A general benchmark are the US guidelines. The U.S. Department of Justice considers a market with a HHI of less than 1,000 to be a competitive marketplace; a HHI of 1,000-1,800 to be a moderately concentrated marketplace; and a HHI of 1,800 or greater to be a highly concentrated marketplace. As a general rule, mergers that increase the HHI by more than 100 points in concentrated markets raise antitrust concerns.

iv. Market power and competition

Market power is the ability of an individual firm (or group of firms) to raise and maintain prices above the level that would prevail under perfect competition. The highest degree of market power is associated with a monopoly, although all firms except those in perfectly competitive markets possess some degree of market power.

The traditional approach to assessing the extent of competition is structural, and involves computing market shares in search of high levels of concentration or positions of market dominance (the specific methodologies will be defined below). However, as noted earlier, large market share may just reflect superior efficiency. Thus, to fully assess whether a firm has market power, one needs to understand how independent the leader(s) is with respect to other firms in the market, how strong their incentives are to try to take share away from the leader and whether they have the ability to do so. Clearly, assessing such details goes beyond the use of simple structural measures of competition, and into an assessment of likely modes of market behaviour. As such, in addition to providing information on how to calculate traditional quantitative measures of competition (ie. concentration ratios), the following section also includes qualitative indicators that should be addressed.

1. What does degree of market power depend on?

a. Countervailing Buyer power.

The power of buyers is the impact that customers have on a producing industry. When buyers are small in number and well organized, price setting becomes more like a bargaining process and less like a unilateral posting of prices. The power of buyers (or suppliers) to affect the methods by which prices are set is as important as their ability to exercise exit options. Furthermore, well organized buyers are often in a position to affect the degree of intra-market rivalry, effectively setting one firm against another, or to encourage new entry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a monopsony - a market in which there are many suppliers and one buyer. In reality few pure monopsonies exist, but there is frequently some asymmetry between the producing industry and buyers.

Some factors to take into account when addressing buyer power are:

- Bargaining leverage
- Buyer volume
- Quantity and quality of buyer information
- Strength of brand identity
- Price sensitivity¹⁶
- Threat of backward integration
- Scope of product differentiation
- Buyer concentration (small in number, or well organized)
- Available substitutes

¹⁶ Evaluating price sensitivity requires further calculations of elasticities

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b. Countervailing Supplier Power

A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits.

Some factors to take into account when addressing supplier power are:

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

c. Barriers to entry:

Rivals do not actually have to be present in a market to exert an effect on the degree of competition in that market, the threat that new firms may enter the industry may, in some circumstances, discipline the behavior of firms who might otherwise enjoy monopoly power. Barriers to entry are unique industry characteristics that define the industry. Barriers reduce the rate of entry of new firms, thus maintaining a level of profits for those already in the industry. From a strategic perspective, barriers can be created or exploited to enhance a firm's competitive advantage.

Examples of barriers to entry are:

High levels of vertical Integration

Research and Development: massive upfront investment in technology may deter potential entrants

Patents and IP Rights

Economies of scale

Access to key inputs/Supplier agreements: exclusive agreements with key suppliers can make it difficult for other manufactures to enter into the industry.

Distributor agreements: exclusive agreements with key distributors or retailers can make it difficult for other manufactures to enter in the industry.

Advertising/Brands: Developing consumer loyalty by establishing branded products can make successful entry into the market by new firms much more expensive.

Sunk costs: Sunk costs cannot be recovered if a firm decides to leave a market. They therefore increase the risk and deter entry.

Government regulation

Natural Monopolies

2. Quantitative Measurements of market power

Although a precise economic definition of market power can be put forward, the actual measurement of market power is not straightforward.

a. The Lerner Index (also called the price cost margin)

The Lerner Index attempts to measure classical market power directly by subtracting a firm's marginal cost from its price, and then dividing the result by the firm's price. Lerner ratios range from 0 to 1. Firms that lack market power show ratios close to zero. As the distance between price and marginal cost increase, the ratio increases from zero to one and it is more likely that the firm possesses significant market power. However, in practice the Lerner Index is difficult to

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calculate as marginal costs can be difficult to obtain (an alternative is to substitute average variable cost).

b. Concentration measures: the Herfindahl-Hirschman Index ("HHI"):

Because application of the Lerner index may be difficult or inaccurate, competition authorities have typically employed measures of concentration as a means of estimating the market power of market participants. The Herfindahl-Hirschman index (as defined above) is the most common index for measuring market power.

c. Market share

Market share, the percentage of sales or capacity that a firm controls in a relevant market is also sometimes used to estimate market power.

However, as mentioned above under the Simultaneity problem of the SCP paradigm, one must be careful in directly linking market share to market power. Instead, it may be the reverse (market power determines market share) that is true.

Please see annex 4 for a summary of the methodology

d. Identification of possible anticompetitive practices performed by the actors previously identified

Whether or not the study finds that market power exists, there are numerous sources that can be utilized to gather information on the possibility of anti competitive actions, including:

- Interviews with industry participants (sector regulators, consumer groups, private sector consultants, managers, government, etc.)
- Searches of relevant media reports
- Examination of recent mergers and acquisitions,
- Information about contracts with suppliers and buyers,
- Information about the structure of ownership in the industry,
- Commission payments,
- Consumer complaints,
- Pricing behaviour,
- Range of prices,
- Possible bundling and tying arrangements.

The following sections (e and f) are ***expected additional work*** to be included. If not included, the consultant should indicate *why* they were unable to do these sections.

e. Measurement of the impact of the identified anti-competitive practices and the potential harm to consumers, competitors and the development of the affected sector or industry.

f. Identification of appropriate policy responses by national authorities. This would provide material for the section VII on public policy recommendations

VI. Conclusions on the analysis of the sector

VII. Public policy recommendations,

VIII. Suggestions for future research and general conclusions (in English and Spanish).

IX. References.

X. Data, and tables summarizing the assumptions formulated for the study (including summary of periodical and academic sources as well as the

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critical evaluation of sources and evidence presented, which will be the basis for the elaboration of the conclusions and recommendations).

Annex 1:

Document (up to 3-pages), to be presented by the consultant within the first two weeks of his/her consultancy.

1. In order to define the scope and parameters of the study, formulate the fundamental problem(s) to be resolved in the study. Secondary questions of the investigation.
2. Briefly indicate value added value of the study and its relevance for public policy makers
3. Describe the relationship, if any, between the study and other related studies within the framework of COMPAL.
4. Describe the methodology and other tools to be used (it could include: legal analysis, econometrics or other quantitative measurements, interview techniques, research from primary sources)
5. In the case of empirical analysis, provide details on the quality of the information or data to be used, including dependent and independent variables, as appropriate
6. Provide a tentative proposal of the possible conclusions of the study taking into consideration the expected benefits and lessons of the target audience of the study which should also be described
7. Finally, describe the problems or main obstacles that could vary the contents and objectives of the final study including reformulating the methodological approach if necessary.

Annex 2: Questionnaire for the competition authorities

1. Please indicate whether the following factors had any role in the selection of the sector for a sector study for the COMPAL programme. Please indicate whether they are: "not relevant", "somewhat important", "important", "very important".

- a. Reliable information on the existence of monopolistic practices, cartels, or other anti-competitive practices (please specify)

- b. Significant increases in prices (in real terms)
- c. High economic concentration
- d. Low economic performance compared to similar countries.
- e. Complaints made by competitors (please specify, if possible)
- f. Complaints made by producers (please specify, if possible)
- g. Complaints made by consumers (please specify, if possible)
- h. Complaints made by other sectors (please specify which sectors)
- i. Complaints made by government officials (please specify)
- j. Results from investigations by non-governmental organizations (please specify)
- k. Information/investigations from/by the media (newspapers, radio, television, internet)
- l. Information from experts or academic institutions (please specify)
- m. Other (please specify)

2. With respect to the "important" and "very important" factors, please explain the motivation of the investigation.

3. Please indicate if there are other sectors you believe should be the subject of a sector study. Please name the sectors and why they have been chosen.

4. Please indicate whether it is "unlikely", "probable", or "very probable" that the following results will be found through the investigation.

- a. Concrete evidence of a firm`s abuse of their dominant position
- b. Concrete evidence of exclusion, or harm to their competitors
- c. Concrete evidence of a cartel
- d. The existence of barriers to entry or other distortions to competition that would be possible to remove through government action (regulatory or deregulatory)
- e. Others (please specify)

5. Please include any other information that you believe is relevant and explains why this particular sector has been suggested for a sector study.

Annex 3: Data Sources

There are many different sources of data and information that can be utilized in a sector study. The following list is only meant to be a suggestion of possible sources and should not be considered to be all-inclusive.

1. General economic and social data:

- Economic Commission for Latin American and the Caribbean (ECLAC) statistical information, **www.eclac.org**, such as the Statistical Yearbook for Latin America and the Caribbean
- United Nations Statistics Division, **www.unstats.un.org/unsd/default.htm**
- United Nations Common Database (UNCDB), **www.unstats.un.org/unsd/cdb**
- UNCDB provides selected series from numerous specialized international data sources for all available countries and areas.
- World Bank Data, **<http://www.worldbank.org/data>**
- The World Bank site contains a vast database of economic, social and other development statistics for all countries of the world.

- United Nations Industrial Development Organization (UNIDO) **www.unido.org/en/doc/3474**

2. Additional price and production data

- FAOSTAT, Food and Agricultural Organization of the United Nations, **www.faostat.fao.org**
FAOSTAT provides access to over 3 million time series and cross sectional data relating to food and agricultural. FAOSTAT contains data for 200 countries and more than 200 primary products and inputs, just in its core.
- IMF Primary Commodity Prices, **www.imf.org/external/np/res/commod/index.asp**
Includes spot prices for about 80 primary commodities with annual, quarterly and monthly prices. The commodities covered include items in the general categories of food, beverages, agricultural raw materials, metals, fertilizers, and energy. Coverage: from 1990 to present
- INFOCOMM, **www.unctad.org/infocomm**
- Market information in the commodities area

3. Country specific statistical sites:

Bolivia

Instituto Nacional de Estadística, **www.ine.gov.bo**

Agencia Para el desarrollo de la Sociedad de la Información en Bolivia, **www.adsib.gob.bo/enlaces**
(Links to: Gobierno Central, Ministerios, Prefecturas, Superintendencias, Entidades Publicas, Municipios, Universidades, Prensa Escrita)

Costa Rica:

Instituto Nacional de Estadística y Censos, **www.inec.go.cr**

El Salvador:

Dirección General de Estadística y Censos, **www.digestyc.gob.sv**

Nicaragua:

National Institute of Statistics and Censuses, **www.inec.go.ni**

Peru:

Instituto Nacional de Estadística e Informática (INEI), **www.inei.gob.pe/home.htm**

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4. Other sources of sector and firm data and information:

- Company Annual Reports
- Reports issued by Governmental Industry regulators
- Interviews with industry participants
- Marketing Surveys
- Trade/Industry associations reports

5. Media and Journal reports (for research on existence of possible anti-competitive)

Newspaper articles:

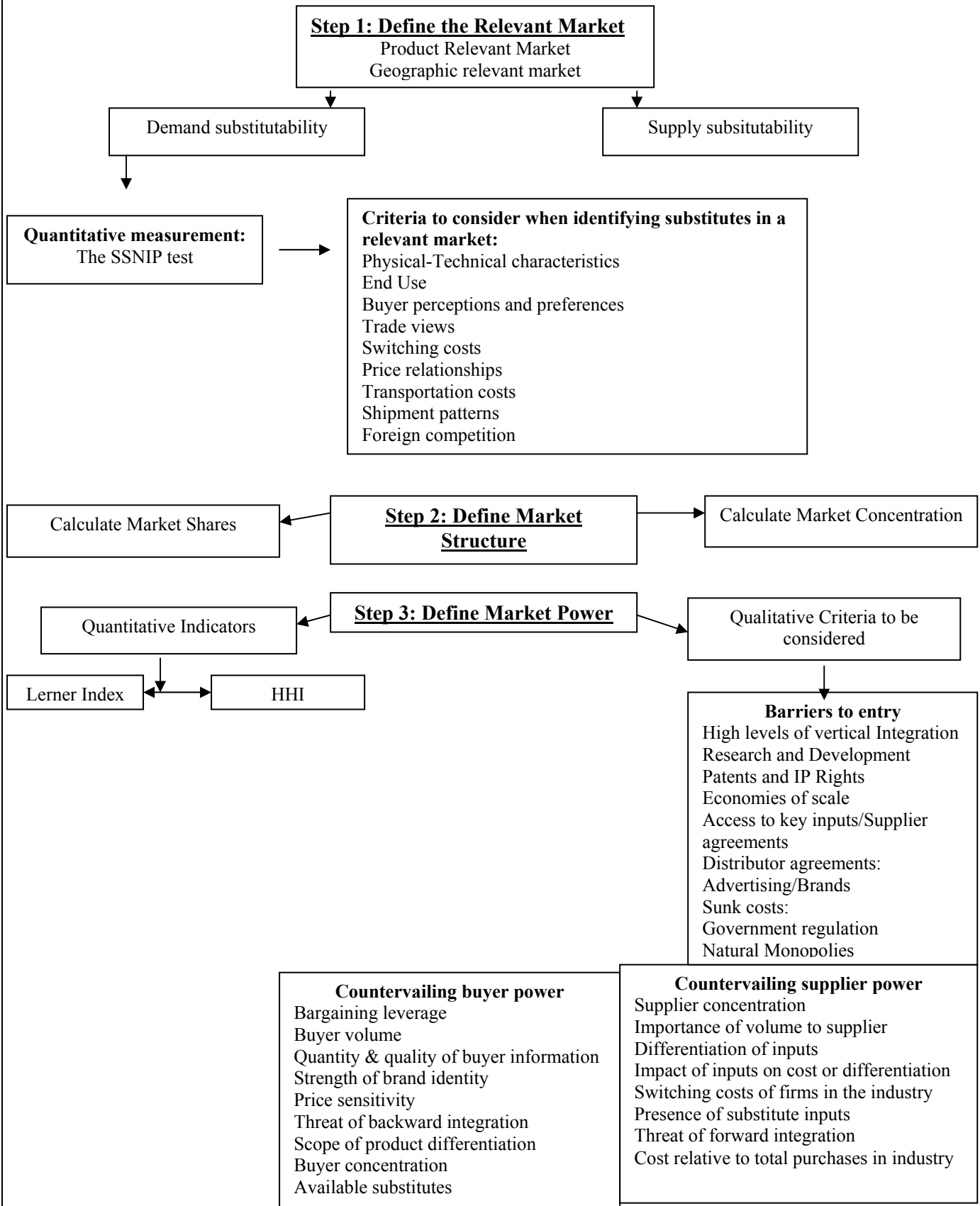
- Lexis-Nexis Professional
Lexis-Nexis has access to over 11,000 news publications (English and other languages)

Journal article search sites:

- Business Source Premier, Econpapers, Google Scholar, Jstor.org, NERA, Highbeam, SSRN.com

Annex 4: Outline of procedure to be employed in section

- a. "The relevant market" and
- b. "Assessing market power through an analysis of market structure, market participation, market shares and market concentration"



Annex 5: Basic Outline of the suggested structure and guidelines

Please note, all headings in **bold** make up the suggested structure for the sector study. All subheadings that are **not bolded** are background information on the relevant economic theory and/or instructions on methodology for the consultant.

- I. **Executive Summary (in Spanish and recommended, in English).**
- II. **Index**
- III. **Introduction (including motivation and objective of market study)**
 - a. **Introduction to the sector and economic context**
 - b. **Motivation for an investigation in this sector**
- IV. List of abbreviations used in the study
- V. Core Text
 - a. Full description of economic sector, industry and products as well as regulatory law for the market under study
 - i. **Description of the institutional framework**
 - ii. **Analysis of prices**
 - b. **The relevant market**
 - i. The importance of the relevant market
 - ii. Definition of the relevant market
 1. Product relevant market
 2. Geographic relevant market
 - iii. Identifying competitive constraints
 1. Demand Substitutability
 - a. Quantitative and qualitative criteria to identify the relevant market
 - b. The SSNIP test: Accepted standard in merger guidelines
 - c. The cellophane fallacy
 2. Supply Substitutability
 - c. **Assessing market power through an analysis of market structure, market participation, market shares and market concentration**
 - i. What is market structure and why is it important
 - ii. Market shares: How to calculate
 - iii. Market concentration
 1. Coefficient Cm: m-firm concentration ratio
 2. Herfindahl-Hirschman Index
 - iv. Market power and competition
 1. What does market power depend on
 - a. Countervailing buyer power
 - b. Countervailing supplier power
 - c. Barriers to entry
 2. Quantitative measurements of market power
 - a. The Lerner Index
 - b. Concentration measures: the HHI
 - c. Market share
 - d. **Identification of possible anti-competitive practices performed by the actors previously identified.**
 - i. Types of information to consider

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Note: The following 2 sections (e and f) make up **expected additional work** to be included. In not included, the consultant should indicate *why* they were unable to do these sections.

- e. **Measurement of the impact of the identified anti-competitive practices and the potential harm to consumers, competitors, and the development of the affected sector or industry.**
- f. **Identification of appropriate policy responses by national authorities (this would provide material for the section VII on public policy recommendations).**

VI. **Conclusions on the analysis of the sector**

VII. **Public Policy recommendations**

VIII. **Suggestions for future research and general conclusions (in English and Spanish)**

IX. **References**

X. **Data and tables**