Chapter 6 Market structure and the leisure sector

Exercise 6.1

The growth of online sales of package holidays is likely to have a noticeable impact on the travel industry. In particular, online sales represent an important new source of contestability in the market. There was a time when travel agents were the only effective way in which most people could book package holidays. However, the growth of online marketing has expanded the range of destinations on offer, and provided much more flexibility for holidaymakers to put together their own packages.

As a market becomes more contestable, competitive pressure is likely to have an impact on the pricing of the product. The fact that the four largest companies in the travel agent business had grown to control a significant part of the market gave them market power. Online selling is likely to dilute that market power, and bring prices towards more competitive levels. However, it should be noted that the investigation of the market for foreign package holidays by the Monopolies and Mergers Commission in the mid-1990s had found it to be 'broadly competitive', so it is not clear how much impact the online selling will have on prices in practice.

Is this increase in online selling wholly good news for the consumer? Before the advent of online selling, ABTA provided some quality control of the activities of travel agents, and provided some assurance to holidaymakers that they would get what they paid for. When someone puts together their own package on the internet, booking the various components of their holiday separately, there is an increased risk of something going wrong. Whether formal regulation is needed, or whether the market will impose its own discipline by seeing that inefficient operators go out of business, only time will tell.

However, in general we would expect competition to benefit the market, if only because it may encourage the conventional travel agents to adopt new practices that will enable them to compete better with online selling.

Exercise 6.2

The question of whether the authorities are justified in intervening to influence the sorts of television programmes being broadcast is essentially a **merit good** argument. The authorities take the view that if there is no regulation at all, the result will be a dumbing down of the programmes being offered. The popularity of certain programmes (which I will not name) provides some evidence for the likelihood of this, perhaps.

The merit good argument rests on the idea that viewing habits influence behaviour. There are 'good-for-you' educational programmes and uplifting dramas (merit goods), and there are other programmes that may encourage anti-social behaviour (demerit goods). Economists tend to hesitate to use these arguments too often to justify policy intervention, as the designation of merit and demerit goods relies heavily on judgements that in turn rest on a rather paternalistic view of government and society.

The fact that I may regard some programmes as rubbish and not worth watching merely reflects my personal tastes, so why should I want to foist these views on others? After all, I do not need to watch what I do not enjoy. In the last resort, the extent to which the authorities are justified in intervening thus depends on the evidence linking the watching of certain types of programmes and anti-social behaviour. I am sure that you have your own views on this subject.

Exercise 6.3

There are many issues here for discussion — and no definitive answer. In your discussion, you need to try to focus on the economic aspects of the situation.

BSkyB's monopoly might be expected to provide an opportunity for the firm to use its monopoly power in order to raise prices, as the theory of monopoly suggests would happen if BSkyB were setting out to maximise profits in the short run.

Whether the firm has exploited its position in this way is not clear. From the perspective of viewers who have decided not to subscribe to BSkyB, it may be argued that they have been priced out of the market. However, it is also the case that in its early years of operation the firm was keen to build the market with a view to reaching the size of audience at which it could attract advertising revenue. This may have meant that it did not set prices as high as would have maximised short-run profits in order to be viable in the longer run.

Nonetheless, the European Commission decision to intervene and break the monopoly of live Premiership broadcasts suggests that it found at least some evidence that there was some anti-competitive behaviour taking place. Cricket aficionados with no access to BSkyB may well feel that they are being deprived of the benefits of watching live cricket on television.

BSkyB has been able to use some degree of price discrimination, by treating home consumers and pub and club venues as separate markets, at least in terms of live football matches. This may have an impact on access for consumers.

The position is further complicated by the way that the advertising revenues have been used to provide a source of funding for the Premiership and for cricket. Arguably, this has benefited the respective sports, and raised quality. Those consumers who do not have BSkyB but who attend matches clearly benefit from this, but without having to pay for a BSkyB subscription. In other words, there is an element of externality involved here.

No doubt you identified other relevant issues; I am sure this is a market that will continue to be controversial.

Exercise 6.4

The fast-food sector has something of an unusual pattern. On the one hand, there are some large chains such as McDonald's, Burger King and KFC, but there is also a multitude of small local fast-food outlets — fish and chip shops, Chinese and Indian take-aways, sandwich bars and so on.

One reason for the proliferation of small local outlets is that there are low barriers to entry, and relatively low set-up costs. The additional exercise in Chapter 3 of this Teacher Guide (p. 20) argued that this might be seen as an oligopoly, as the various outlets engage in strategic competition with each other. Another way of regarding this is that this segment of the market seems to correspond well to the model of monopolistic competition, with a variety of small firms all trying to achieve product differentiation by offering different styles of food. (This illustrates well why economists have sometimes achieved a reputation for disagreeing with each other. In this case, we can see elements of different forms of market structure in this particular sector, and cannot definitively state that one is correct.)

The central issue to this question is that if barriers to entry are low and set-up costs are limited, how is it that the large chains have managed to become so firmly established — to the extent that they are not confined to the UK but are operating globally? Part of it is to do with branding. The McDonald's brand has become so well known that the firm can achieve customer loyalty. Its reputation is such that customers know what to expect if they go to any branch. Furthermore, by standardising the product, it may be possible to achieve economies of scale in procurement that a local fish and chip shop would not be able to attain. These may give a competitive advantage to these firms. On the other hand, the local outlets may survive partly because not everyone wants to eat McDonald's or Pizza Hut food. Consumers also like diversity.

Additional exercise

Cinemas in Basingstoke and Edinburgh

In September 2005, the OFT referred to the Competition Commission (CC) a completed takeover of Ster Century by Vue Entertainment Holdings. Before the merger, Vue was the third-largest operator of cinemas in the UK, with 42 cinemas with 409 screens; Ster owned and operated 6 cinemas in the UK with 73 screens; these were located in Basingstoke, Cardiff, Edinburgh, Leeds, Norwich and Romford.

In investigating the merger, the CC had first to define what was the relevant market. It decided to restrict the market definition to cinema exhibition, and that the appropriate scale for market investigation was a local geographic area. The main focus was on cinemas within a 20-minute drive-time of the acquired cinemas. Evidence suggested that cinema-goers tend to decide which film they wish to see first of all, and then where to see it as a secondary decision, normally going to the closest one, although there may be some variation in the quality of cinema, which may be reflected in ticket prices. It was not thought that the merger would significantly increase Vue's negotiating position with screen advertising contracts, distributors or other suppliers, so there would not be an impact at the national level.

In Basingstoke, the merger meant that Vue owned the only two cinemas within a 20-minute drive of the city. Vue argued that they were in competition with cinemas in Winchester, Alton, Bracknell, Reading and Woking, but the CC did not find this to be a strong argument. As a result, a substantial lessening of competition (SLC) was expected to occur, which was likely to lead to higher prices for cinema tickets and a reduced incentive to maintain quality.

The situation in Edinburgh was quite different. After the merger there were still a 'significant number of competing cinemas and screens' in the city. The CC therefore took the view that there would be no SLC resulting from the merger in this case.

Vue mounted a defence of its position in Basingstoke. One argument put forward related to the market for DVDs, arguing that the DVD market was constraining cinemas in their pricing policy. In addition, Vue offered to agree a price cap restricting any increase in ticket price in Basingstoke to the average percentage ticket price rise across the whole Vue cinema circuit for each type of ticket. Vue also promised to maintain quality by spending at least as much as the average across its circuit on site maintenance. Vue also promised to keep both cinemas open, and to offer a broad range of films to ensure consumer choice.

a Explain what is meant by 'relevant market' (line 5) and why it is important for an investigation of this sort.

b Why might it be important to check whether the merger would significantly affect Vue's bargaining power with its suppliers (lines 11–13)?

c How convincing do you find Vue's defence (lines 22–28)?

d What decision would you have taken if you had been the CC?

Additional exercise

Discussion points

a The first issue to be tackled in any investigation by the CC is to decide what market it is that is under investigation. This entails identifying which products can be regarded as being substitutes, and hence in competition with the firm under investigation. Only then is it possible to calculate market shares, and to gauge the extent to which the firm faces effective competition in its operations. One way of doing this would be to estimate the cross-price elasticity of demand between two products. If the demand for one product is highly sensitive to the price of another product — for example, if an increase in the price of a cinema ticket in Basingstoke were to have a significant impact on the demand for cinema performances in Winchester, then it would be reasonable to regard them as being in competition. Even without calculating the elasticity formally, it is possible to make a reasonable judgement about the likelihood that a Winchester resident would travel along the notoriously congested M3 to go to a cinema in Basingstoke rather than going to the local cinema.

b If the merger had given Vue a significant national market share, then it could negotiate deals on advertising, film distributors or the firms who supply it with ice cream, popcorn etc. This would allow the firm to increase its profits at the expense of the suppliers. However, this did not apply in this case.

c The CC was certainly not convinced. It noted that cinema ticket prices had been rising over the previous 5 years, unlike the prices of DVDs, suggesting that the price of DVDs does not constrain the price charged by cinemas. The CC was also unhappy at the notion of agreed price caps, arguing that although this might be effective in the short run, it would be costly to monitor over a longer time frame. In addition the CC did not anticipate that there was a possibility of new market entry in the city. The argument that Vue would spend at least the average maintenance cost was also unconvincing, and would potentially cause problems at the time when refurbishment became necessary. On the question of choice, the CC felt that an undertaking by Vue to keep both cinemas open would be the minimum necessary in order to ensure that consumer choice was safeguarded.

d *I don't know what you decided, but the CC decided that the only remedy to safeguard the consumers would be for Vue to sell one of the two Basingstoke cinemas. It ruled to this effect in early 2006.*