Memorandum

To: The Editor

*SA Journal of Economic and Business Sciences*

From: Mike Holland

Jannie Rossouw

Jessica Staples

Date: 6 March 2015

Reviewers’ reports: *FOCAL POINT PRICING: A CHALLENGE TO THE SUCCESSFUL IMPLEMENTATION OF SECTION 10A (INTRODUCED BY THE COMPETITION AMENDMENT ACT*)

We wish to thank you for your general comment and the three reviewers’ reports on our article with the title *FOCAL POINT PRICING: A CHALLENGE TO THE SUCCESSFUL IMPLEMENTATION OF SECTION 10A (INTRODUCED BY THE COMPETITION AMENDMENT ACT).*

In considering these reviewers reports, the general comments of the Editor and amendments to the article, we are particularly encouraged by the comment of the first reviewer, stating that “I recommend accepting, provided the above changes have been implemented” and the third reviewer who states that “This paper is generally suitable for publication”. Moreover, the second reviewer recommends the publication of the paper after review, which is also very encouraging.

This memorandum describes the changes made to the article, while we attach two copies of the revised article: One with tracked changes and one final copy, i.e. without tracked changes.

We deal with the editorial comment and the reviewer reports according to number as received from the journal.

**Editor’s comment:**

Although all three unanimously agreed that the topic covered was relevant and interesting and in line with the objectives of this journal, it seems that the biggest stumbling block for publication is that the paper seems to be outdated: *This remark was made by the second reviewer, but we wish to point out that the provisions of Section 10A, introduced by the Competition Amendment Act, has yet to come into force despite the fact that more than five years have lapsed since the Competition Amendment Act was promulgated. Our research is therefore still relevant despite the time lapse since the promulgation of the Act.*

I attach all three of the reviews for your perusal and suggest that you work through their comments. The comments were made constructively in an attempt to help you to get this paper published: *We indeed found the reviewer reports useful in improving the paper and convey our thanks to the reviewers*.

**Reviewer 1**

This paper discusses the economics and policy implications of the so-called ‘complex monopoly’ amendment to South Africa’s competition laws. The aim of this change is to broaden the scope of cartel-like conduct prosecutable by competition authorities. The current Act – consistent with competition laws elsewhere – requires competition authorities to prove the existence of an agreement among competitors in order to prove collusion. In other words, market outcomes (for example, similar prices) are not accepted as sufficient proof of collusion. If all cartels were, in fact, guided by sophisticated agreements on how the cartel is to set prices or allocate market shares, this requirement would not be problematic. However, firms can also collude tacitly, i.e. using private communication and signals, but not committing to a more structured agreement. These types of cartels (often called ‘concerted action’ conduct) are difficult to distinguish from cases where firms adopt similar prices but have not communicated in any way (often called ‘conscious parallelism’). Focal point prices, often provided by government, exacerbate the problem and can indeed facilitate conscious parallelism. Given that policymakers believe that there are many such tacit cartels in South Africa, the ‘complex monopoly’ amendment was proposed. The amendment will render conscious parallelism illegal under certain circumstances and is therefore quite problematic from an economics perspective, given the above comments. The paper discusses this problem in detail. It is a timely paper that fills an important void in the South African competition policy literature and I recommend publication with minor revisions set out below: *We find this general comment of the reviewer most encouraging for our resubmission of the paper*.

Substantive comments

The author presents a satisfactory account of the literature on tacit collusion. The combination of the game theory literature with focal point theory is particularly interesting: *Likewise, this is a most encouraging remark*.

There is one dimension on which the paper can be improved. Illegal tacit collusion – i.e. concerted action in the US parlance – also involves communication. While there is no explicit agreement – i.e. verbal or written communication between cartelists – there is communication via price signalling, etc. This is what makes illegal tacit collusion so difficult to detect: competition authorities must infer whether firms are communicating using certain market signals, even though communication does not take a verbal or written form. It is therefore incorrect to argue, as the author does, on page 11: “…tacit collusion where a mutual understanding or meeting of minds exists even though there is no communication”. In general, I think that the author should avoid the term ‘meeting of minds’. Conscious parallelism – including convergence on a focal price point provided by government – also involves a conscious meeting of minds, but is considered legal to the extent that there is no communication (even tacitly): *In this instance we have removed the reference to ‘meeting of minds’ as we agree with the reviewer’s assessment.*

On page 7, the first paragraph reads: “However, a problem that the Commission frequently encounters is that even if the market conditions suggest the existence of collusive conduct, the Commission cannot prosecute this conduct unless there is some form of agreement or contact between competitors…”. I would exclude this paragraph, as it leaves the impression that the Commission should prosecute conduct based on market conditions. But an important part of the paper argues that market behaviour – including parallel prices – alone cannot be the basis for cartel prosecution. In fact, based on the conclusion in the paper, I would suggest that this is not a problem,

as it would be consistent with economic theory. It is sufficient to start with the next paragraph on the DTI, which, in my limited understanding, was the activist force for this change in the competition legislation (rather than the Commission): *As recommended by the reviewer, we have removed this paragraph.*

The paper is a suitable contribution to this journal, marrying an important amendment to competition policy with the academic literature. I recommend accepting, provided the above changes have been implemented: *Based, inter alia, on this assessment, we resubmit the paper*.

**Reviewer 2**

I thank you for the opportunity to review this paper. I am however wondering about several aspects of this submission. The first is that it appears that the paper was submitted about a year ago to the SAJEMS, the second is that the paper refers to events that happened in 2009 as if they were in the future. This leads me to think this paper is rather outdated and needs serious updating. It appears it

may have been written in 2008 and submitted in reaction to the promulgation in March 2013 of the Competition Amendment Act 1 of 2009, which was then effective from April 2013. It appears the Act will be used of in an inquiry into the private healthcare market. For publication, the paper would at the least have to be updated to take into account “recent” events, in particular whether the Act was made use of since April 2013 and how. If no use has been made of its new dispositions, then I would suggest waiting until the conclusion of, for example, the inquiry into the healthcare market in South Africa: As is explained above, this paper deals with one aspect of the Amendment Act that has not yet been introduced despite the time lapse since the promulgation of the Amendment Act*. For this reason the paper is therefore not dated, as is also explained above*.

The paper is unnecessarily long and repetitive in its arguments. A definition when first stated does not need to be stated another time. I would be happy if the authors were asked to halve the size of the paper, so as to force them to focus and shorten their exposition: *We have reduced the length of the paper as far as we could, without losing the focus of the analysis. This is a constructive comment of this reviewer and advice that we put to good use*. *While we hardly managed to reduce the length of the paper, we managed to deal with the additions without adding to the overall length by revising and shortening in certain instances.*

The authors could give more examples of academic studies that have tried to establish econometrically the existence of tacit collusion in a market. In particular, the authors are unclear about what policies could be used to implement the prohibition against focal point pricing. If indeed it is very difficult to prove tacit collusion and in particular tacit collusion based on the use of focal points, then policies could be used that deter the use of focal point pricing. I would suggest referring to the experimental literature on tacit collusion and focal points, which might give the authors some indications of how tacit collusion can be broken off: *This remark left us a bit perplexed in view of the earlier remark that we should shorten, rather than expand the paper. We have followed the earlier approach as is explained above.*

The promised case study of South African commercial banks, which I would have expected to illustrate tacit collusion through the use of focal point pricing, is very short and does not seem to indicate, as the authors say, that “focal point pricing is prevalent in the SA banking industry”. Much more work with more data and more examples would be needed to establish this statement: *We completely agree with this observation and no longer describe these observations as a case study. This is a very useful comment from this reviewer*.

The authors use very specialized language that is unlikely to be known to general economists outside of the specialized field of competition law. “complex monopoly conduct”, “consciously parallel conduct” are not really defined – the authors give conditions under which they may occur, but little on how such conduct is defined. It would be good if the authors explained those terms and how they compare with such terms as tacit collusion or coordination. A term, “express collusion”, raise the question of whether the authors meant “explicit collusion”?: *We used less specialised language where possible and included explanations where possible; however, we were cognisant of the remark about the length of this paper by this reviewer discussed above*.

Only the last paragraph in the abstract really focuses on the main theme in the paper: *We revised the abstract to take care of this remark*.

Body: (Does layout of the manuscript enable the reader to ‘follow the story line’) Yes: *No comment*.

Originality: (Does the manuscript contain adequate new information to justify it publication in an ISI indexed journal) No, the paper is out‐dated, see section 1: *Please see the discussion above*.

Relationship to literature: (Does the manuscript demonstrate an adequate understanding of relevant literature? Are appropriate sources cited?) Yes: *We are grateful to notice this remark*.

Research methodology: (Is the manuscript’s argument founded on an appropriate base of theory, concepts or other ideas? Is the research on which the manuscript is based, well designed and are the methods employed appropriate?) No, the case study is particularly disappointing: *Please see the remark about the case study above*.

Results: (Are the results presented clearly and analysed appropriately, and do the conclusions adequately tie all the elements of manuscript together?) The conclusion is too vague as it merely states that "a number of difficulties are likely to arise with the section 10A amendment" without telling the reader exactly what those difficulties are: *We have revised the conclusion to deal with this comment*.

**Reviewer 3:**

This paper is generally suitable for publication: *We are grateful about this encouraging comment*.

This paper currently answers what is largely a theoretical problem but it does so in a clear way. While Competition Amendment Act which was adopted and assented to, in 2009, introduces complex monopoly conduct, the Competition Amendment Act provides that it will come into operation on a date to be fixed by the President of South Africa by proclamation in the Government Gazette. To date, the Competition Amendment Act has not yet entered into force (note that this is 5 years later). This is largely a reflection of the issues contained in the paper: *Please see also the discussion above; this reviewer identifies the relevance of this matter addressed in the paper*.

Current literature is used to build the question for the problem: *This is an encouraging observation*.

One suggestion would to be place in conclusion the issues in error cost framework, the framework makes the following assumptions: First, both Type I (false positive, where innocent firms are sanctioned or subject to significant costs imposed by investigations and litigation) and Type II (false negative, where violators are not sanctioned) errors are inevitable in competition law cases because of difficulties in distinguishing pro-competitive business practices from anticompetitive behaviour. Second, the social costs associated with Type I errors are generally greater than the social costs of Type II errors because market forces can be expected to offer some correction with respect of Type II errors. Third, optimal competition policy rules will minimise the expected sum of errors costs subject to the constraint that the rules be relatively simple and reasonable administrable: *We note this comment and agree that an analysis of this nature can be interesting, but we decided not to include this discussion in view of the second reviewer’s remark that the paper has to be shortened. The inclusion of this discussion would have lengthened the paper and we are of the view that such inclusion, while having the negative result of an even longer paper, will only have limited marginal benefit for the analysis in the paper*.

We thank the reviewers for their comments and trust that we have addressed all matters raised by them to the satisfaction of the editor.

Kind regards

Mike Holland Jannie Rossouw Jessica Staples