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OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

What is Competition on the Merits?

Introduction

There is broad agreement among competition agencies from OECD countries that the purpose of competition policy is to protect competition, not competitors. In pursuing that objective, many agencies and courts have repeatedly used the phrase "competition on the merits" to explain and justify their views on how to distinguish conduct that harms competition from conduct that advances it. Yet that phrase has never been satisfactorily defined. This has led to a discordant body of case law that uses an assortment of analytical methods. That, in turn, has produced unpredictable results and undermined the term's legitimacy along with policies that are supposedly based on it.

Generally, the expression "competition on the merits" implies that a dominant enterprise can lawfully engage in conduct that falls within the area circumscribed by that phrase, even if the consequence of that conduct is that rivals are forced to exit the market or their entry or expansion is discouraged. Despite many years of competition law enforcement across OECD countries, however, both the perimeter of that area and the underlying principles that ought to define it remain largely unclear. Although it may be easy to agree that certain types of conduct are outside or inside the acceptable area, it is not always easy to agree on why they are, and for other types of conduct it has proven difficult even to reach agreement on whether to locate them in or out of the acceptable area in the first place. Nevertheless, when courts and practitioners have referred to "competition on the merits" in their efforts to delineate which behaviour is lawful, which is not, and why, they have tended to do so in a manner that presumes a common understanding of what the phrase means. In other words, it has served too often as a shortcut that glosses over the difficult work of defining clear principles and standards that embody sound competition policy.

Understandably, dominant businesses have become apprehensive about the likelihood of receiving arbitrary treatment from competition authorities and courts who criticise their conduct while relying on the official-sounding, but in fact untethered, term "competition on the merits" to justify their enforcement actions. Consequently, there is a growing sense that the standards for evaluating dominant firm conduct under the competition laws should be re-examined and clarified. If competition on the merits is to be a helpful concept, it must facilitate the task of sorting out harmful, exclusionary conduct from healthy, competitive conduct in a principled manner. ■

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What matters – conduct's form or its effects?

While it is widely agreed that the purpose of competition policy is to protect competition, not competitors, there is less agreement on how to go about doing that. To determine whether dominant firms are harming competition, agencies in many countries use a primarily effects-based approach, focusing on the economic impact that conduct has on consumers and competition. Agencies in a number of other countries, such as Germany and Korea, use a more form-based approach that focuses on how conduct can be categorised. Economic analysis still plays an important role in those jurisdictions, and the form-based approach may provide greater legal certainty and faster resolutions than effects-based methods. Some commentators believe, however, that a significant problem with form-based approaches is that the same type of conduct often can be either "normal competition" or "abusive competition", depending on the circumstances. That would mean that there is no obvious form-based way to assess whether behaviour constitutes competition on the merits and that attempts to assess potentially abusive conduct in that manner are prone to both false positives and false negatives. Focusing on the conduct's economic effect, they argue, is essential to making an accurate determination of its true nature, and thus it is worthwhile even if it requires more time than a form-based approach. Otherwise, competition law enforcement might not be consistently aligned with competition policy's economic purpose.

There is an inherent tension between fostering legal certainty, ease of administration, and accuracy. Form-based systems may provide more certainty and are relatively easy to administer, but also may generate results that are inappropriate, given what the actual market effects are. Case-by-case or effects-based approaches may yield results that are more appropriate given a practice's actual effects, but having to uncover every detail in every case would be slow, unworkable, and unenforceable. Either approach, driven to excess, produces unattractive results. ■

Is there a better way?

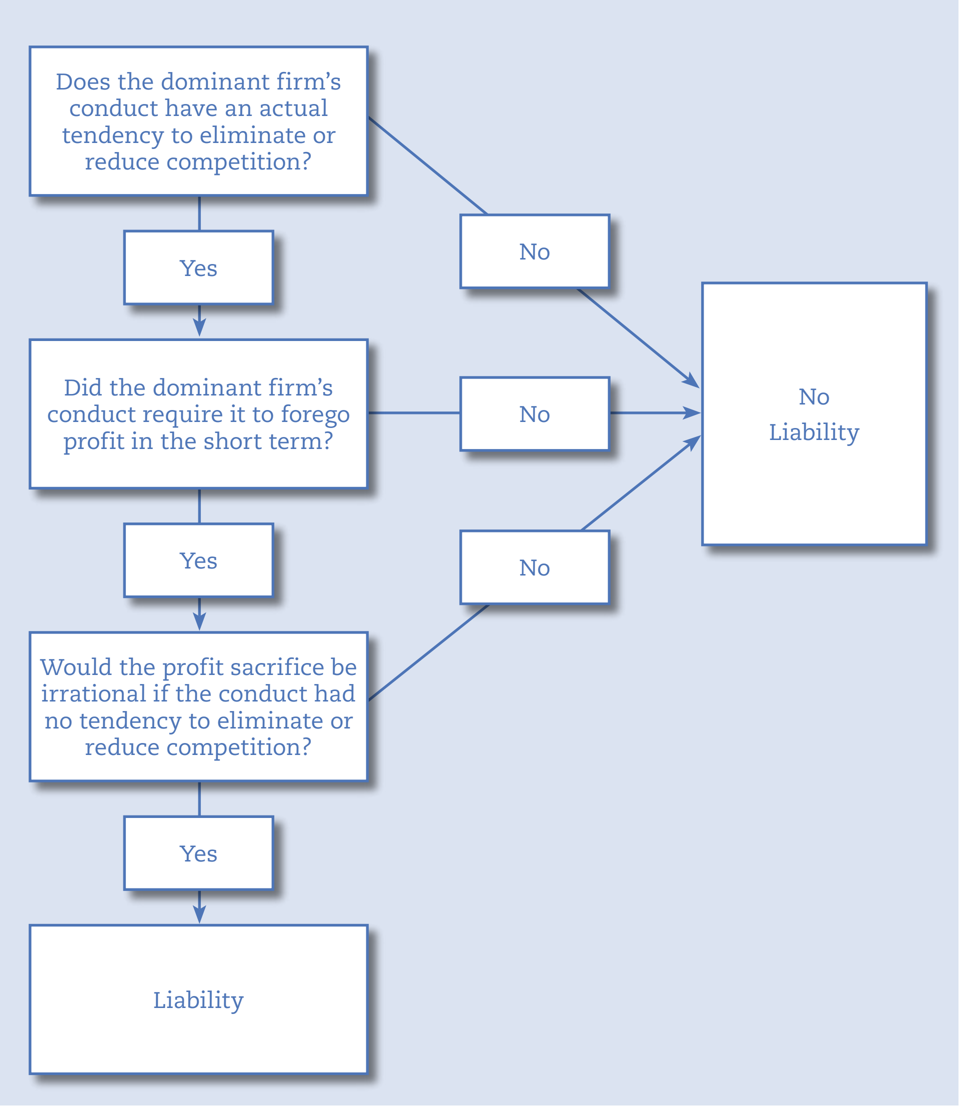
In some cases it is easy to conclude that the conduct in question is obviously competition on the merits, however that term is defined, and that no abuse of dominance or monopolisation has occurred. The more difficult cases, however, have generated some dissatisfaction with the ambiguity of many competition statutes as well as with the lack of clear definitions for terms like competition on the merits. That dissatisfaction has prompted scholars to propose a number of more specific tests for detecting harmful conduct. These include the profit sacrifice test, the no economic sense test, the equally efficient firm test, and various consumer welfare balancing tests. Most agree that no single test is suitable for every type of case, but there is also some variation with respect to the test that different agencies tend to favour. Each of the four major types of tests has been used by courts and competition authorities. Other tests, such as one devised recently by Professor Einer Elhauge, have been proposed from time to time as scholars continue trying to pinpoint what competition on the merits is. Each test has certain strengths and weaknesses. ■

What are the profit sacrifice and no economic sense tests?

The profit sacrifice test states that conduct should be considered unlawful when it involves a profit sacrifice that would be irrational if the conduct did not have a tendency to eliminate or reduce competition. One form of this test is useful for capturing predatory pricing conduct, but it does not appear to be a good test in other types of cases because it is both over-inclusive and under-inclusive. It is over-inclusive because it can capture certain types of behaviour that increase consumer welfare even though they also exclude competitors. For example, research and development costs for a new drug may be so high that spending the money to develop it would be rational only if the drug is so effective that it excludes competitors and gives the innovating firm market power. But is it sound policy to discourage such investments? On the other hand, some conduct may entail no short run profit sacrifice at all yet still be harmful to competition. Diagram 1 contains a flow chart describing how the profit sacrifice test works.

Diagram 1.

THE PROFIT SACRIFICE TEST



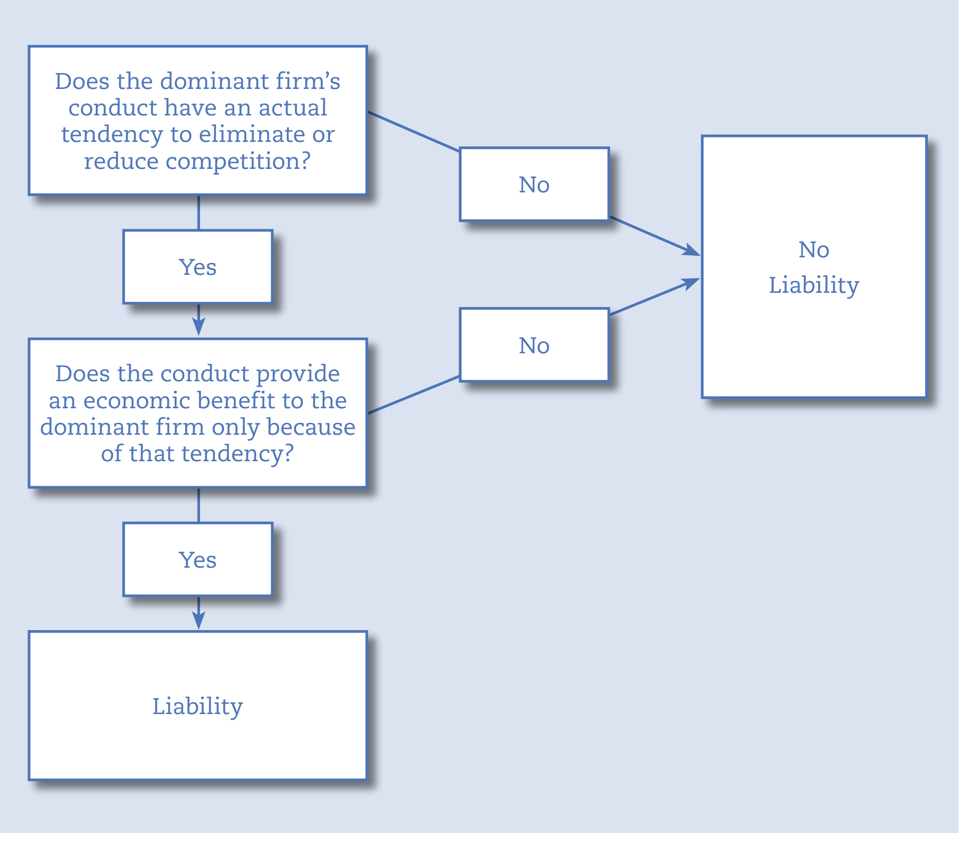
The no economic sense test states that conduct should not be condemned unless it would make no economic sense but for a tendency to eliminate or lessen competition. This test avoids under-inclusiveness because it does not require profit sacrifice. The test can be used offensively, *i.e.*, to argue that conduct was exclusionary because it made no economic sense, and defensively, *i.e.*, to demonstrate that conduct should not be condemned because it did make economic sense. It seems, however, that difficulty with some conduct that has mixed effects is characteristic of this test, too. Diagram 2 contains a flow chart describing how the no economic sense test works. ■

What is the equally efficient firm test?

The equally efficient firm test (which is sometimes called the "as efficient competitor" test) states that conduct should be unlawful if it would be likely to exclude a rival that is at least as efficient as the dominant firm is. The test is geared toward distinguishing harm to competition from harm to competitors. It relies on the idea that, without some kind of "bad" conduct, a dominant firm cannot eliminate equally efficient rivals. This test may be too lenient, though, if it is interpreted as allowing the elimination of new firms that are currently less efficient but that would have eventually become equally or more efficient than the incumbent if they had been able to survive long enough. Furthermore, an equally efficient firm might be able to enter a

Diagram 2.

THE NO ECONOMIC SENSE TEST



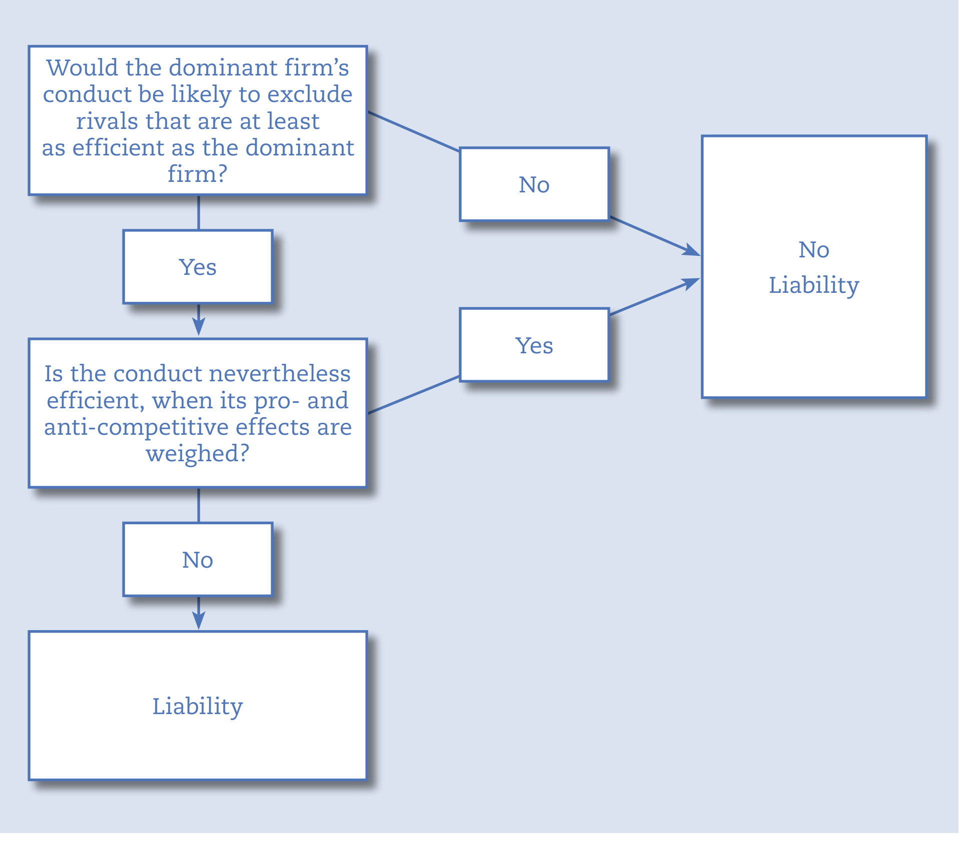
market and survive, but that does not always mean it would be able to exert competitive pressure. The mere likelihood that it could survive, therefore, is not necessarily enough to guarantee that competition will be preserved. ■

What are consumer welfare balancing tests?

Consumer welfare balancing tests determine whether conduct should be unlawful by requiring decision-makers to weigh the positive and negative effects that the conduct has on consumer welfare. There are several varieties of consumer welfare tests. They all have a degree of intuitive appeal because they attempt to use consumer welfare effects themselves, rather than indirect factors such as profit sacrifice, as the gauge of dominant firm conduct. Unfortunately, although it may be possible to determine whether conduct enhances or reduces consumer welfare in some cases, it can also be quite challenging, if not impossible, to measure the magnitude of those changes. Yet when conduct has both positive and negative effects on consumer welfare, a balancing step is necessary to determine which effect is stronger. It is therefore difficult to have confidence that balancing tests can be applied accurately, objectively, and consistently. Furthermore, it is not clear what the appropriate time horizon should be when applying this test, but that choice has very important implications for dynamic strategies such as predatory pricing. ■

Diagram 3.

THE EQUALLY EFFICIENT FIRM TEST

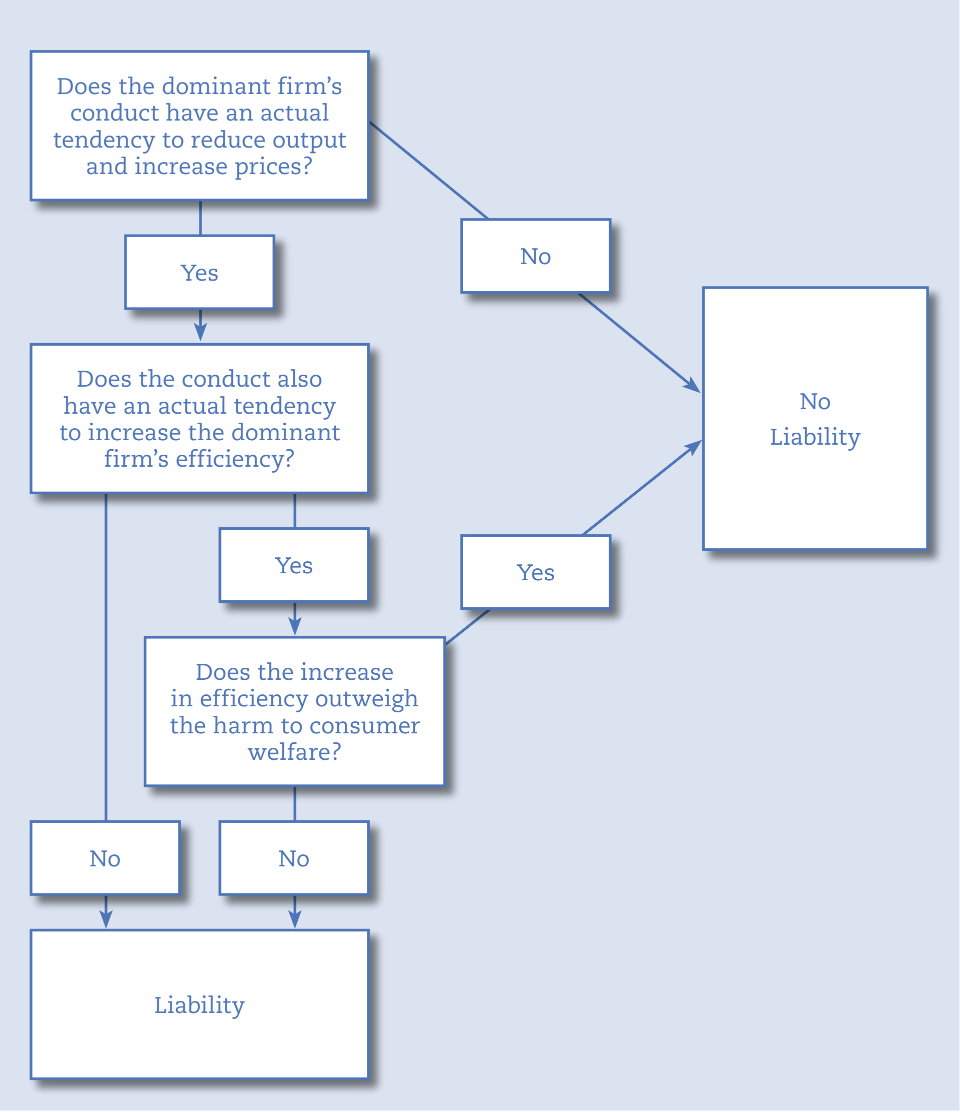


What else can be done?

It is desirable to make the reasoning in competition agencies' decisions more transparent because doing so will clarify how competition laws are being interpreted and enforced. Although it is useful to discuss, promote, and apply specific tests, the overall method that courts and agencies ultimately use to identify abusive conduct is going to be based on the precedents set by reasoned decisions. There are opportunities to draw lessons both from matters in which proceedings were not brought and from those in which action was taken. Some agencies, however, do not routinely issue written statements of their reasoning in no-action cases. It could be quite helpful to themselves and to the public if they would start doing so because it would lead to a greater understanding of how any similar matters that arise in the future are likely to be analysed. Furthermore, making the reasoning in all agency decisions transparent can spark debate and lead to refinements

Diagram 4.

A CONSUMER WELFARE BALANCING TEST



in both the competition laws and the enforcement of those laws. Ireland's competition authority, for example, publishes its no-action decisions with an accompanying analysis, and the US Federal Trade Commission aims to explain its no-action decisions, as well.

Delegates from several countries expressed the view that decisions regarding unilateral conduct should offer both legal certainty and clear, structured analysis of market facts in an economic effects-oriented way. More key facts can be brought into play in decisions to take action, even if form-based approaches might not require it. No-action decisions likewise need to be very clear in explaining why conduct that might appear to be superficially unlawful is actually competition on the merits when looked at soberly in the light of market facts. ■

For further information

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For further reading

OECD, Competition on the Merits (Best Practices Roundtable) (2005)
Available on the Internet: *www.oecd.org/dataoecd/7/13/35911017.pdf.*

OECD, Predatory Foreclosure (Best Practices Roundtable) (2004)
Available on the Internet: *www.oecd.org/dataoecd/26/53/34646189.pdf.*

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