

OECD Journal of Competition Law and Policy



OECD 

Volume 4/No. 1

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Volume 4, No. 1



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié en français sous le titre :

Revue de l'OCDE sur le droit et la politique de la concurrence

Volume 4, n° 1

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The OECD *Journal of Competition Law and Policy* is a unique resource for competition experts in business, law, economics, consulting and academia. Drawing on the best of the recent work of the OECD Committee on Competition Law and Policy, it provides insight into the thinking of competition law enforcers while focusing on the practical application of competition law and policy.

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The Editors

2002 Subscription (4 issues)

ISSN 1560-7771

Prices: € 175 US\$185 £113 ¥ 24 950 MXN 1 400

24 2001 21 1 P ISBN 92-64-19094-5

24 2001 22 1 P ISBN 92-64-19095-3

24 2001 23 1 P ISBN 92-64-19096-1

24 2001 24 1 P ISBN 92-64-19097-X

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REVIEW OF COMPETITION LAW AND POLICY IN THE CZECH REPUBLIC

Note by the Editor

Since 1998, the OECD has been reviewing the progress of regulatory reform in its member countries. These reviews are prepared by the OECD Secretariat and examined by delegates from all Member countries. The final product, however, remains under the responsibility of the Secretariat and does not necessarily represent the views of any OECD Member country. Competition policy is one of several areas under review in each country.

Czech Republic was reviewed under the regulatory reform programme in 2000. The entire report, including this chapter was published by the OECD in 2001 under the title “Regulatory Reform in Czech Republic”.

This chapter was prepared by Michael O. Wise.

Review of Competition Law and Policy in the Czech Republic

*By Michael Wise**

The Czech Republic competition law is based on familiar European substantive concepts. Features that were appropriate for a transition setting are being revised in anticipation of EU accession. The enforcement body was at one time a separate Ministry; now, the Czech Office for the Protection of Economic Competition is an independent agency. Provisions for exemption are well controlled, and the processes for applying it are working well; however, stronger enforcement powers may be needed to deal with secret cartels. The major challenge of improving competitiveness by completing the reform of the inherited industrial structure requires solving problems of corporate governance and financing. The role of competition policy in that task will be modest.

Executive Summary

Competition policy is central to regulatory reform, because its principles and analysis provide a benchmark for assessing the quality of economic and social regulations, as well as motivate the application of the laws that protect competition. The Czech Republic's conception of competition policy fully supports pro-competitive restructuring and reform. Its institutions generally have the tools they need to effectively promote competition policy. The competition laws and enforcement structures are well-established and competent to the task of preventing or correcting collusion and monopoly now and after reform, and they have been active in encouraging pro-competitive reform since they were created.

* Michael Wise, formerly a senior official of the United States Federal Trade Commission, is now a consultant to the OECD.

Executive Summary *(cont.)*

The situation in the Czech Republic must be understood in the context of 10 years of reform, as the country moved from central planning to a modern market economy. Competition policy principles have been integrated into the general policy framework for regulation from the beginning of that process. For several critical years, which included key decisions about privatisation and restructuring, competition policy was a separate Ministerial portfolio, so that considerations of competition policy were raised directly in intra-government decision-making. Anti-competitive constraints have been avoided, for the most part, in designing new regulatory institutions, but in restructuring energy monopolies, some competition concerns remain.

The most important challenge is not one of competition policy, as that is usually conceived, but of improving competitiveness by completing the process of reforming the inherited industrial structure. This will require solving some of the problems of corporate governance and financing that have emerged from the privatisation process. Managers need more incentive – or discipline – to produce efficiently and deploy assets productively. Among other reforms, this may require a clean-sweep replacement of the cumbersome bankruptcy law, where incremental tinkering is postponing fundamental solutions. Competition policy may play a modest role, sorting out investment cross-holdings that may inhibit competition and reviewing proposed restructuring deals to ensure against the creation of market power.

As reform stimulates structural change, vigorous enforcement of competition policy is needed to prevent private market abuses from reversing the benefits of reform. The Czech Republic has a mainstream competition law and a healthy enforcement body, the Czech Office for the Protection of Economic Competition (“OPEC”). The Czech competition law is based on familiar European concepts, prohibiting restrictive agreements and abuse of dominance and requiring approval for major mergers. Some of the original features that were particularly appropriate for a transition setting, such as a strict test for dominance and merger control, are being revised now to conform to EU norms in anticipation of accession and to make it more useful as a tool of reform. The administrative approach in applying the competition law has worked well, but new tools are needed to deal with violations, such as horizontal cartels, that the parties do not report to the authorities. No sector is exempt from competition policy, and provision for special regulatory exemptions appear to be well controlled. Most recurring issues are similar to those faced by all competition enforcers, such as self-regulatory barriers to professional services and increasing pressure for rules to protect competitors against abuse of economic dependence.

Executive Summary (cont.)

A complement to competition enforcement is competition advocacy, the promotion of competitive, market principles in policy and regulatory processes. Some new institutions, such as sectoral regulators in infrastructure industries, were the result in part of such advocacy. As these new bodies are established, more formalisation of their relationship to the OPEC may be appropriate. And as the country implements its new regional layer of government, competition policy must remain vigilant about the risk of distortion of competition by government bodies.

In addition to the threshold, general issue, which is whether regulatory policy is **consistent** with the conception and purpose of competition policy, there are four particular ways in which competition policy and regulatory problems interact:

- Regulation can **contradict** competition policy. Regulations may have encouraged, or even required, conduct or conditions that would otherwise be in violation of the competition law. For example, regulations may have permitted price co-ordination, prevented advertising or other avenues of competition, or required territorial market division. Other examples include laws banning sales below costs, which purport to promote competition but are often interpreted in anti-competitive ways, and the very broad category of regulations that restrict competition more than is necessary to achieve the regulatory goals. When such regulations are changed or removed, firms affected must change their habits and expectations.
- Regulation can **replace** competition policy. Especially where monopoly has appeared inevitable, regulation may try to control market power directly, by setting prices and controlling entry and access. Changes in technology and other institutions may lead to reconsideration of the basic premise in support of regulation, that competition policy and institutions would be inadequate to the task of preventing monopoly and the exercise of market power.
- Regulation can **reproduce** competition policy. Regulators may have tried to prevent co-ordination or abuse in an industry, just as competition policy does. For example, regulations may set standards of fair competition or tendering rules to ensure competitive bidding. Different regulators may apply different standards, though, and changes in regulatory institutions may reveal that seemingly duplicate policies may have led to different outcomes.
- Regulation can **use** competition policy methods. Instruments to achieve regulatory objectives can be designed to take advantage of market incentives and competitive dynamics. Co-ordination may be necessary, to ensure that these instruments work as intended in the context of competition law requirements.

1. Competition Policy Foundations

Competition policy motivated by dynamic efficiency and modelled on European methods, adopted and developed during the decade of transforming the Czech economy and government institutions, strongly supports continued regulatory reform. The same principles may motivate solutions to the most important and difficult current reform tasks, of restructuring major enterprises to make them competitive in modern conditions. But competition policy tools will play a secondary role in these tasks, which will require reforms to the institutions of corporate governance and financing.

1.1. Context and history

Competition policy developed in the Czech Republic along lines similar to most of continental Europe until 1948. The first explicit statute on the subject was adopted in the late nineteenth century, when Bohemia already had the most highly developed industry under the Habsburg monarchy. That law declared that agreements among traders to increase prices to the disadvantage of customers were void.¹ Under this approach, which was common at that time, price fixing agreements were not necessarily prohibited by public law, but the conspirators could not use private law remedies to enforce their agreements against defectors. Later, in the inter-war period, Czechoslovakia adopted a program to register cartels and control abuses.² Cartels were permitted, subject to oversight to correct abuse. This law was not repealed, but it could not be enforced in the first two years after World War II.

From 1948 to 1989, when the economy was subject to monolithic central direction and planning, “competition policy” to regulate the resulting monopolies would have been incoherent. Some rules about unfair competition were added to the national planning regulations during the brief reform period in 1968-69.³ In 1970, a rule against abuse of dominance was added to the Economic Code. But this rule was not a precursor of a move toward wider application of competition concepts. It addressed organisations dealing with each other in the context of a national plan, not a competitive market. And it was actually invoked only once. The central planning model appears to have been followed more consistently through the 1980s in Czechoslovakia than in some of its neighbours, which had begun to introduce market-pricing mechanisms and to anticipate the need to create new institutional structures for a market economy before 1989.

As the country revamped its institutions to shift to a market economy in 1990, one of the first steps was to draft a framework competition statute. The law on the “protection of economic competition” (“Competition Act”) was adopted in 1991.⁴ This law drew on European models and substantive concepts, but it also included features designed to address particular national problems, notably the historically

monopolised structure of most markets. Not only were the “natural” monopolies in the utility sector still unregulated and unreformed, but also manufacturing and other industries were typically monopolies, at least within a domestic market. To apply the new law, the Czech National Council established the Office for the Protection of Economic Competition (“OPEC”), which began operation 1 July 1991. The competition agency’s institutional status was upgraded in 1992, when the OPEC became the Ministry of Economic Competition. In that position, competition policy could intervene more directly in the privatisation process. After the June 1996 parliamentary elections, and as part of a general reorganisation of administration offices and functions, it became an “office” again.⁵ The OPEC’s headquarters is in Brno. Geographic separation from the other governmental institutions in Prague was intended to represent and re-enforce the competition policy body’s independent decision-making position.

The basic competition law will be replaced by a new law to make its text conform fully to EU competition policy. The most significant changes will involve the treatment of mergers and the definition of dominant position. The new Czech law will also follow the EU’s approach to exemptions and *de minimis* issues. This new law has been in preparation since 1999 (EC, 1999, p. 33). The government approved the amended competition act in August 2000, and the Parliament approved it in April 2001. It will enter into force on 1 July 2001.

1.2. Policy goals

The Competition Act’s statement of purpose says that it is to protect “economic competition” against elimination, restriction, or “distortion”. The draft new Competition Act would expand the law’s coverage some, by adding a purpose to prevent threats, as well as actual, elimination, restriction, or distortion of economic competition. The meaning of “economic competition” is not elaborated further, but must be understood from the remainder of the law and from the practice of the OPEC in applying it.

The OPEC’s description of its competition policy objectives emphasises the dynamic aspect of competition as an incentive for innovation, competitiveness, and growth. Competition rules are also applied to promote liberalisation – to prevent private practices that undermine liberalisation – and integration into the EU and other international market settings. A third goal is consumer welfare, broadly understood. Decisions applying competition policy consider the effects on ultimate consumers, including how those benefits are distributed.

Competition policy, as understood at the OPEC, follows an economic approach, but one that addresses structure and process more directly than outcome. In enforcing the law to create efficient competition, the OPEC’s purpose is to remove barriers and increase the number of firms in a market. Establishing

¹²

those structural conditions for rivalry is then expected to produce the desired outcomes, of pressure for innovation, improved competitiveness, higher quality jobs, and ultimately better products at lower prices for consumers.

1.3. *Competition policy in reform*

The economic conception of competition policy supports a pro-competitive reform agenda. The dynamic elements, stressing innovation, competitiveness, and growth, are also goals of the broader restructuring that accompanies the establishment of institutions to support a market economy. One of the challenges in establishing vigorous market competition in the Czech Republic is to complete the unfinished business of the first stages of transformation, by putting in place stronger mechanisms of corporate governance and finance, making insolvency procedures more effective, and further reducing the state's exposure to industry demands for relief. The motivation and conception of competition policy is consistent with these other policy goals, although its tools and technical doctrines are not directly useful in helping to reach them.

Privatisation was a principal task of the early 1990s, accompanying the liberalisation of prices and trade. During that period, the process of restructuring state enterprises into joint stock firms and putting some of their shares into private ownership was substantially completed. The privatisation ministry closed down in 1996. But the state still retains substantial interests in many sectors, either directly or through the shareholdings of state-controlled banks. These interests amount to 43% of the equity (by market value) in all joint stock companies in the country, and 46% of the equity in the largest 60 companies (OECD, 2000, p. 75). The National Property Fund holds shares not only in 38 strategic companies (which it must hold by law), but also in 258 non-strategic companies, including golden shares in 60 (OECD, 2000, p. 82). Sectors involved include energy, mining, steel, banking, and agricultural land (EC, 1999). Two waves of voucher privatisation left most private shares in the hands of investment funds. The intention was to create a wide constituency for equity ownership and hence market-based reform, while concentrating holdings enough to give some investment bodies an interest in disciplining management. The investment funds' holdings in a single firm are capped at 20%, so no single fund can technically hold a controlling share. The funds are typically tied to or controlled by banks, so that banks are both the major creditors and ultimately the principal shareholders of major industrial firms (EIU, 2000).

Assigning competition policy to a separate Ministerial portfolio from 1992 to 1996 permitted more intimate participation in government privatisation decisions. The ministry's goal was to strengthen enterprise competitiveness and help shape the development of a competitive environment, by removing or at least

weakening former monopolies and dominant firms and preventing the formation of new ones. Competition ministry representatives were on the boards of the telecoms, railways, and newspaper-postal delivery firms in 1995-96, participating in the early stages of privatisation planning. Although it is no longer in the government, the OPEC still participates directly in the privatisation process by submitting (non-public) opinions to the Commission for Privatisation. The Competition Act contains “temporary” provisions that were designed to ensure that the process of creating a privately-owned economic base would not simply transform state-owned monopolies into privately-owned ones (Art. 19). State property was not to be transferred to new ownership – even to a state-owned joint-stock company – if that would create a firm with a dominant position. If there was reason to think the new firm might be dominant, the office proposing the transaction had to prepare a market analysis and consult with the OPEC; if the OPEC disapproved of the proposed transaction, the dispute would be resolved by the cabinet. Similarly, local authorities were required to ensure that assets were not spun off to firms that would have dominant positions in local markets (Art. 20).⁶ A vivid example of the importance of getting the structure right is the bus system. When the bus firms were privatised, the OPEC advocated keeping the terminals in public hands, to prevent private monopolisation. Experience confirms the wisdom of that advice: where the private firms control the terminals too, they try to favour their own operations and limit their competitors’ access. Similarly, the OPEC has opposed including oil pipelines in the chemical industry holding company, out of concern that the holding company could tie up feedstock and thus prevent competitive entry into the chemical industry.

The ownership and governance structure that resulted from the privatisation process may have created some potential competition problems. Voucher privatisation produced fragmented and non-liquid shareholdings, in a market where information about issuers is inadequate. Capital interconnections among banks and the privatisation investment funds could have created conditions supporting collusion or concerted practices affecting product market competition. For example, until 1998 the investment funds of two banks might together control 40% of an issuer, a share that could be smaller than legal “control” but large enough to exercise influence. Yet the creation or persistence of such holdings need not be reported to the OPEC. Moreover, a single bank’s direct or indirect holdings could extend to a substantial share of a sector, but that fact would be unlikely to be reported to the OPEC. And in both situations, competition policy might be powerless to correct such structures that may inhibit competition (OECD CLP, 1998a). The risk of such combinations was substantially reduced when the ceiling for investment fund holdings in a single firm was reduced to 11% in 1998. Of course, competition policy would prohibit overt conduct that restricts competition. And now that the state property has been transferred to joint-stock companies, further

privatisation transactions are likely to take the form of acquisitions or mergers, and as such they will be subject to the general law enforcement oversight attention of the OPEC.

An important consequence of the more thorough-going central planning tradition in Czechoslovakia, compared to its neighbours, is that it is taking a long time and considerable effort to restructure the heavy-industry backbone of the Czech economy into economically viable, coherent units (Fingleton *et al.*, 1996, p. 11). Some of the accumulated problems of restructuring Czech industry have ended up in the hands of the Revitalisation Agency, which is moving into a few large, troubled firms to reorganise their operations, clean up their debts, and offer the viable parts for sale. So far, it has taken on only 9 firms, and few have completed the process. Some of the Revitalisation Agency's initial projects involve firms that are, or should be, operating in international markets such as steel, vehicles, and industrial machinery. Disposing of their assets to other firms may not raise substantial competition issues, because the likely markets are large. But about 4 500 firms remain in the portfolio of the *Konsolidacni banka*, which was set up in 1991 as a vehicle for taking over the bad debts of ailing enterprises (EIU, 2000). If the Revitalisation Agency gets further into this inventory of problem firms, domestic markets may be involved and the need for competition policy oversight could be greater. It could be important to set up a way to do this in advance, rather than review transactions only pursuant to standard merger approval procedures. Otherwise, competition policy may be injected at an awkward moment, when there is already a deal in hand and the government may be anxious to declare an end to the problem even if there are adverse competition consequences.

Similar problems could arise in other restructuring actions in the course of bankruptcy proceedings. The Czech bankruptcy process is widely recognised to be unsatisfactory, particularly in its application to larger firms. For small and medium sized enterprises, the bankruptcy process closes down firms and pays off creditors reasonably quickly. But the bankruptcy process is not often applied to large, failing firms; instead, many of them are being restructured in a more *ad hoc* way or through the Revitalisation Agency. The bankruptcy law has been revised 11 times, but some critical changes still have not been made. Changes recently made (or proposed) in the laws about bankruptcy and liquidation, and related parts of the criminal code, address some technical problems and try to make the process work more smoothly.⁷ But the bankruptcy law is still directed principally to the goal of paying off creditors, rather than to facilitating or encouraging reorganisation to make assets productive. The criterion for requiring that a firm be liquidated, rather than reorganised, is stringent. Small creditors can block a settlement, even if holders of most of the debt would approve it. High-priority creditors that do not participate in the settlement do not necessarily lose their claims as a result. These weaknesses discourage resort to the legal process and encourage

the alternative of repeated *ad hoc* bailouts. It will be difficult to break this cycle as long as the tax administration and state-owned banks are the firms' principal creditors (and, indirectly, shareholders). State-connected creditors may be reluctant to demand restructuring that would weaken the state-connected banks' balance sheets and lead to job losses.

2. Substantive Issues: Content of the Competition Law

If regulatory reform is to yield its full benefits, the competition law must be effective in protecting the public interest in markets where regulatory reform enhances the scope for competition. The Czech competition law is based on familiar European concepts, prohibiting restrictive agreements and abuse of dominance and requiring approval for major mergers. Some of the original features that were particularly appropriate for a transition setting are being revised now, to conform to EU norms in anticipation of accession and to make it more useful as a tool of reform (Box).

2.1. Horizontal agreements

The basic rule prohibiting restrictive agreements is substantially identical to the EU treaty provision. The prohibition extends to agreements and concerted practices among competitors and to decisions by trade associations, if they may result in the "distortion" of economic competition. (In the Czech law, the general term "distortion" is defined to include restriction or elimination, too.) The list of specifically prohibited agreements – to fix prices or terms, limit or control production, divide markets, boycott other firms, discriminate against some buyers, or impose unconnected obligations – also follows the EU list, plus agreements to boycott. Agreements to fix prices or divide markets are prohibited *per se*. The sanctions the OPEC may impose include fines, orders prohibiting the agreement (or other conduct) and orders to remedy the effects of the violation. Fines can range up to CZK 10 million or 10% of the party's net turnover for the previous calendar year (Art. 11 and Art. 14). This basic range of sanctions also applies to violations of the law's other basic prohibitions.

Three types of agreement are exempt from the statutory prohibition: "terms cartels" about payment and delivery conditions, "rationalisation" and "specialisation" agreements, and *de minimis* agreements that affect less than 5% of a national market or 30% of a local one [Art. 3(4)]. The OPEC must approve each such agreement, but a "silence is consent" rule deems an agreement approved if the OPEC has not acted within 60 days after receiving it.

The *de minimis* rule depends on market share and hence on market definition. The OPEC defines markets by the same means for all purposes. Product markets are defined principally from the consumer's perspective. Products or services that

The competition policy toolkit

General competition laws usually address the problems of monopoly power in three formal settings: relationships and agreements among otherwise independent firms, actions by a single firm, and structural combinations of independent firms. The first category, **agreements**, is often subdivided for analytic purposes into two groups: “horizontal” agreements among firms that do the same things, and “vertical” agreements among firms at different stages of production or distribution. The second category is termed “**monopolisation**” in some laws, and “**abuse of dominant position**” in others; the legal systems that use different labels have developed somewhat different approaches to the problem of single-firm economic power. The third category, often called “**mergers**” or “**concentrations**”, usually includes other kinds of structural combination, such as share or asset acquisitions, joint ventures, cross-shareholdings and interlocking directorates.

Agreements may permit the group of firms acting together to achieve some of the attributes of monopoly, of raising prices, limiting output, and preventing entry or innovation. The most troublesome **horizontal** agreements are those that prevent rivalry about the fundamental dynamics of market competition, price and output. Most contemporary competition laws treat naked agreements to fix prices, limit output, rig bids, or divide markets very harshly. To enforce such agreements, competitors may also agree on tactics to prevent new competition or to discipline firms that do not go along; thus, the laws also try to prevent and punish boycotts. Horizontal co-operation on other issues, such as product standards, research, and quality, may also affect competition, but whether the effect is positive or negative can depend on market conditions. Thus, most laws deal with these other kinds of agreement by assessing a larger range of possible benefits and harms, or by trying to design more detailed rules to identify and exempt beneficial conduct.

Vertical agreements try to control aspects of distribution. The reasons for concern are the same – that the agreements might lead to increased prices, lower quantity (or poorer quality), or prevention of entry and innovation. Because the competitive effects of vertical agreements can be more complex than those of horizontal agreements, the legal treatment of different kinds of vertical agreements varies even more than for horizontal agreements. One basic type of agreement is resale price maintenance: vertical agreements can control minimum, or maximum, prices. In some settings, the result can be to curb market abuses by distributors. In others, though, it can be to duplicate or enforce a horizontal cartel. Agreements granting exclusive dealing rights or territories can encourage greater effort to sell the supplier's product, or they can protect distributors from competition or prevent entry by other suppliers. Depending on the circumstances, agreements about product combinations, such as requiring distributors to carry full lines or tying different products together, can either facilitate or discourage introduction of new products. Franchising often involves a complex of vertical agreements with potential competitive significance: a franchise agreement may contain provisions about competition within geographic territories, about exclusive dealing for supplies, and about rights to intellectual property such as trademarks.

The competition policy toolkit (*cont.*)

Abuse of dominance or **monopolisation** are categories that are concerned principally with the conduct and circumstances of individual firms. A true monopoly, which faces no competition or threat of competition, will charge higher prices and produce less or lower quality output; it may also be less likely to introduce more efficient methods or innovative products. Laws against monopolisation are typically aimed at exclusionary tactics by which firms might try to obtain or protect monopoly positions. Laws against abuse of dominance address the same issues, and may also try to address the actual exercise of market power. For example under some abuse of dominance systems, charging unreasonably high prices can be a violation of the law.

Merger control tries to prevent the creation, through acquisitions or other structural combinations, of undertakings that will have the incentive and ability to exercise market power. In some cases, the test of legality is derived from the laws about dominance or restraints; in others, there is a separate test phrased in terms of likely effect on competition generally. The analytic process applied typically calls for characterising the products that compete, the firms that might offer competition, and the relative shares and strategic importance of those firms with respect to the product markets. An important factor is the likelihood of new entry and the existence of effective barriers to new entry. Most systems apply some form of market share test, either to guide further investigation or as a presumption about legality. Mergers in unusually concentrated markets, or that create firms with unusually high market shares, are thought more likely to affect competition. And most systems specify procedures for pre-notification to enforcement authorities in advance of larger, more important transactions, and special processes for expedited investigation, so problems can be identified and resolved before the restructuring is actually undertaken.

the consumer can interchange or substitute, taking into account characteristics, prices, and intended uses, are in the same relevant market. Geographic markets are defined principally by differences in conditions of competition between the areas where the firms involved operate and other areas. Factors considered include the nature of production and the costs of transportation.

Parties to any agreement can apply to the OPEC for an exemption, for which the criteria are similar to those applied by the EU (Article 5). An otherwise prohibited agreement might be exempted if it benefits the whole economy (by improving production or distribution or promoting technical or economic progress), if consumers get a fair share of the benefit, if the restrictions are indispensable to attaining these benefits – that is, there is no less restrictive way to do

it – and if competition is not eliminated for a “substantial part” of the market. In theory, an exemption could be granted for an agreement that had a net negative effect on competition; however, the OPEC has never found that such an agreement would be in the public interest. To date, the provisions for “block” exemption by decree (Art. 6a) have never been applied to horizontal agreements. Several block exemptions are being prepared, though, to become effective with the revised competition act. These will cover research and development, specialisation agreements, insurance, and transport. They are based on an economic approach, the OPEC’s experience with individual exemption applications in these areas, and the EU block exemptions for the same subjects. Treating these kinds of agreements with block exemptions should save on administrative costs, for applicants and the OPEC, and thus make resources available for enforcement against hard-core problems.

Relatively few enforcement actions have targeted hard-core horizontal price fixing so far, but the subject is getting increasing attention. Of the OPEC’s 54 decisions in 1999 involving restrictive agreements, only 3 dealt with horizontal price fixing and one dealt with market division. An agreement among 4 poultry producers to set minimum prices for sales to chain stores was prohibited and the firms were fined CZK 7.8 million. An early case, from 1994, challenged a co-ordinated price increase among the major coffee producers, effected through their trade association. Large fines, of CZK 7 million against the firms and CZK 50 million against the association, were overturned on appeal. (One reason for reversal was that the agreement could not be proved in enough detail because a key witness had left the country.)

Regulation of services and professions has raised many issues about horizontal co-ordination. The most common problems are efforts to prevent new entry and to control the forms of service. The OPEC has also encountered price-fixing and minimum fee schedules among architects, assessors, contractors, and court experts. Professional and trade associations often contend that they operate pursuant to special authorising legislation that permits derogation from the Competition Act.⁸ The number of cases involving professional associations has declined in recent years, as the OPEC’s strict enforcement approach and public education efforts have increased the level of compliance.

As the problem of horizontal cartels has become a higher priority, the OPEC in 1999 set up a separate department to specialise in the subject. The department’s tasks include to improve the OPEC’s means of detection and to devise and impose more effective remedies. The department is studying how other OECD countries handle these issues, such as by holding natural persons liable and offering lenient treatment to those who disclose the cartel to the enforcement authorities and provide evidence to prove the case against it. The OPEC is now considering adopting its own leniency program (Box).

The EU competition law toolkit

The law of the Czech Republic follows closely the basic elements of competition law that have developed under the Treaty of Rome (now the Treaty of Amsterdam):

- **Agreements:** Article 81 (formerly Article 85) prohibits agreements that have the effect or intent of preventing, restricting, or distorting competition. The term “agreement” is understood broadly, so that the prohibition extends to concerted actions and other arrangements that fall short of formal contracts enforceable at civil law. Some prohibited agreements are identified explicitly: direct or indirect fixing of prices or trading conditions, limitation or control of production, markets, investment, or technical development; sharing of markets or suppliers, discrimination that places trading parties at a competitive disadvantage, and tying or imposing non-germane conditions under contracts. And decisions have further clarified the scope of Article 81’s coverage. Joint purchasing has been permitted (in some market conditions) because of resulting efficiencies, but joint selling usually has been forbidden because it amounts to a cartel. All forms of agreements to divide markets and control prices, including profit pooling and mark-up agreements and private “fair trade practice” rules, are rejected. Exchange of price information is permitted only after time has passed, and only if the exchange does not permit identification of particular enterprises. Exclusionary devices like aggregate rebate cartels are disallowed, even if they make some allowance for dealings with third parties.
- **Exemptions:** An agreement that would otherwise be prohibited may nonetheless be permitted, if it improves production or distribution or promotes technical or economic progress and allows consumers a fair share of the benefit, imposes only such restrictions as are indispensable to attaining the beneficial objectives, and does not permit the elimination of competition for a substantial part of the products in question. Exemptions may be granted in response to particular case-by-case applications. In addition, there are generally applicable “block” exemptions, which specify conditions or criteria for permitted agreements, including clauses that either may or may not appear in agreements (the “white lists” and “black lists”). Any agreement that meets those conditions is exempt, without need for particular application. Some of the most important exemptions apply to types of vertical relationships, including exclusive distribution, exclusive purchasing, and franchising.
- **Abuse of dominance:** Article 82 (formerly Article 86) prohibits the abuse of a dominant position, and lists some acts that would be considered abuse of dominance: imposing unfair purchase or selling prices or trading conditions (either directly or indirectly), limiting production, markets, or technological development in ways that harm consumers, discrimination that places trading parties at a competitive disadvantage, and imposing non-germane contract conditions. In the presence of dominance, many types of conduct that disadvantage other parties in the market might be considered abuse. Dominance is often presumed at market shares over 50%, and may be found at lower levels depending on other factors. The prohibition can extend to abuse by several firms acting together, even if no single firm had such a high market share itself.

The EU competition law toolkit (*cont.*)

- **Reforms in administration:** Recent and proposed reforms of EU competition policy reduce the scope of the prohibition against vertical agreements and would eliminate the process of applying for exemptions for particular agreements. Instead, exemption criteria would apply directly in decisions applying the law, and these decisions would increasingly become the responsibility of national competition authorities.

2.2. Vertical agreements

The same provision of the Competition Act applies to vertical agreements, in the chain of distribution, as to horizontal agreements among competitors. The new competition act will define the two separately and apply a different, less stringent market share threshold to the prohibition of vertical agreements.

Vertical agreements are generally regarded as less harmful, because they often improve distribution and benefit consumers by improving reliability and availability. So vertical agreements about distribution are usually considered “rationalisation” agreements, which enjoy a “statutory exemption” (Art. 3, paragraph 4). These agreements must be notified to the OPEC, but they are presumed to be approved if the OPEC has not objected in 2 months. The *de minimis* rule also often applies to vertical agreements, as do the standard criteria for exemption. One decree with the effect of a “block exemption” is now in place, as of March 2000, dealing with the terms of franchise agreements. The decree, which follows the EU’s franchise block exemption regulation and EU decisions, should reduce administrative and compliance costs, by eliminating most of the individual exemption applications for franchise contracts, which had tripled between 1997 and 1998. The statute permits the OPEC to grant an individual exemption to a vertical agreement that impairs competition on the grounds that the claimed benefits to efficiency or technical progress outweighed concerns about competition, or that no less anti-competitive means could be found for achieving the same benefits. But the OPEC has never granted such an individual exemption.

The OPEC applies the statutory prohibition strictly against resale price maintenance agreements. A 1997 case imposed a fine of CZK 400 000 for fixing resale prices of frozen foods. But a supplier’s “recommendation” about resale price would not necessarily be prohibited, as long as the supplier does not put

pressure on the distributor to maintain the recommended price (for example, by threatening to cut off the distributor's supplies). Agreements that result in total territorial protection for a distributor are also strictly prohibited. Exclusive sale or purchase agreements have been approved where they can improve the efficiency of distribution. But the OPEC has taken action against a pattern of exclusive supply agreements that, taken together, had the effect of blocking entry by small and medium sized firms. An example was the practice of major breweries to enter exclusive supply contracts with restaurants. No single agreement would have impaired competition for the whole market, but the contracts tied up 60% of the restaurants in the country for 2 or 3 major brewers and significantly reduced the outlets available for small and medium sized brewers.

The new competition law will be accompanied by a new block exemption for vertical agreements, modelled on the new EU regulation adopted in 2000.

2.3. *Abuse of dominance*

Abuse of a dominant position is prohibited, but simply holding such a position is not. The particular abusive practices that are identified in the Competition Act are similar to those prohibited by other European laws. These include imposing unfair terms on other parties to contracts (especially enforcing obligations that are disproportionate to the other parties' reciprocal obligation), demanding acceptance of unusual, supplementary obligations as a condition of entering a contract, applying dissimilar conditions to different trading partners that put those partners at a competitive disadvantage, and curtailing production or technical development in order to attain "unjustified economic benefits to the prejudice of buyers" [Art. 9(3)]. The sense of these prohibitions implies that the law is concerned about relative bargaining power, as much as about the adverse effects of abuse on overall economic efficiency. The statute's list is illustrative, and other practices not mentioned in the Act could also be treated as abuses.

A position of dominance is a condition in which a firm is not exposed to any substantial competition; in a monopoly, the firm faces no competition at all [Art. 9(1)]. The Competition Act defines a dominant position in terms of the share of a relevant product and geographic market: 30% or more of annual sales (or purchases). The market share definition appears to be a conclusive presumption, which cannot be refuted by a showing that the firm actually faces substantial competition. Dominant firms (and firms that reach the dominance market threshold together, through an agreement) are required to notify the OPEC [Art. 9(1)]. Evidently, this is an annual obligation, since dominance is defined in terms of annual market share.

Fines, either for abuse or for failing to notify the OPEC of a dominant position, are the same as for all violations (CZK 10 million or 10% of the firm's annual net

turnover). In addition, where competition is seriously distorted, the OPEC can order divestiture, that is, dividing the company or selling some of its assets to another [Art. 11(2)]. This power has not actually been used yet, though.

The statute's specific prohibitions do not include charging a high price, but that does not mean the law could not be used to find that high prices are an abuse of dominance. Most early complaints alleged abuse of dominance in the form of price increases. The OPEC rejected most of those complaints because it did not want to take on the role of price regulator. Rather, the objective is to prevent dominant enterprises from using their power against consumers and other competitors and to expand entry possibilities. Despite this history of scepticism about these early complaints, in December 2000 the OPEC launched three proceedings about pricing practices in cable TV service.

Increasingly, there are demands to apply competition law to protect suppliers against abuse of "economic dependence". The OPEC's views about this subject, which can overlap with traditional rules about unfair competition, appear to be evolving. A 1998 OPEC note about the Czech retail sector reported no complaints from suppliers and few competition problems, although there were some commercial disputes about sharp practices, such as delaying payment of invoices and pressuring suppliers for promotional favours (OECD CLP, 1998*b*). On balance, the 1998 report described a still-fragmented retail market in which chain stores were introducing efficiencies and buying from local sources. Some were engaged in loss-leader pricing, and in response to this intense competition, smaller retailers were forming joint purchasing and advertising groups.

In the intervening three years, though, the OPEC has concluded that disparate bargaining power between suppliers and retailers requires legislative action, so that smaller firms will not be forced out of the market. A study from 1998-99 was stimulated by complaints about abuse of economic dependence in the food market, such as demands for discounts or shelf space allowances that left suppliers no profit. Despite recognising that one result of the changes in the distribution system is lower consumer prices, the OPEC is concerned that eliminating small suppliers' brands reduces consumer choice, while increased private branding by retailers creates a barrier to entry by other suppliers. One approach to the situation, to apply the existing general principles to these market relationships, could be to define smaller markets in retail trade, following the approach of EC case law, while making clear that dominance can also appear on the buying side.

Other than a few cases about tying and exclusive dealing, most applications of the law about abuse of dominance have been in utility and infrastructure markets. Local utility monopolies often refused to connect a customer unless the new customer paid a lump sum fee that was not included in the firm's normal

charges, or unless the new customer paid the overdue, unpaid bills of the old customer at that location. Those cases declined in numbers after it became clear that the OPEC would object to the practice. In telecoms, the OPEC intervened to end a tying arrangement, in which the dominant mobile phone operator required customers to use a voice-mail service too. In cable TV, the OPEC has investigated repeated complaints about high prices, leading to consideration of regulating these local “natural” monopolies.

The new law will expand the list of specified abuses to include refusing to grant reasonable access to an infrastructure transmission or distribution network that is an essential facility. This addition will make the general competition law apply explicitly to one of the most common problems encountered in restructuring traditional network monopoly industries. The new law will also generalise the substantive principle by incorporating the principles used by the EC Court of Justice, basing “dominance” on market power, rather than simply on market share. Market share will be a significant criterion, but not the only one, and not necessarily a conclusive one. The 30% threshold in the statute and the annual reporting requirement will be dropped. One market-share criterion will remain: a firm with a share below 40% will be presumed not to be dominant, but that presumption could be overcome by a demonstration of dominance in a particular case.

2.4. Mergers

The OPEC can prohibit mergers that would create or strengthen a dominant position or that may significantly distort competition (Art. 8a). The burden is on parties to a merger to demonstrate that any distortion of competition is outweighed by economic benefits. The OPEC’s power to approve (or disapprove) mergers extends to the whole economy, without exception. No other body or sectoral regulator has the power to approve (or disapprove) mergers or acquisitions.

The OPEC’s decision about a merger begins with industry structure, particularly the parties’ post-transaction market share. The OPEC also considers the parties’ “economic and financial strength”, barriers to entry (paying closest attention to patents or other intellectual property or high capital requirements), vertical integration, and capacity utilisation. The statute has not directly followed the EC merger regulation, but the OPEC’s merger analysis has been informed by it, and the OPEC has often followed the EC’s findings defining relevant markets. The OPEC has developed a methodology for assessing structural factors quantitatively on a 25 point scale, with higher scores indicating stronger competition. This is an internal guideline, first proposed in 1992, which was particularly useful during that period of major structural change. The goal was to use this scale as a general tool, but the method has proven to be better adapted to mergers than to other kinds of

violations. There is now a time series of data using this scale in merger and privatisation decisions. Based on this experience, the OPEC generally finds that a score below 16 corresponds to an insufficiently competitive environment.

The notification and review process is being revised. Now, parties to a full merger must apply to the OPEC for approval before submitting the proposed change in the business register. If the acquisition is less than a full merger, the parties must submit an application to the OPEC within a week of signing the contract [Art. 8a(3)]. The Competition Act does not set any special deadlines, so the OPEC's action is subject to the generally applicable deadlines in the administrative code, which can be up to 60 days for complex matters. Applications are published in the Business Bulletin, in effect inviting comment from affected parties. Applications thus cannot be confidential. Sanctions for merging without requesting approval (or in defiance of an OPEC disapproval) include an order prohibiting the firms from performing their contract, divestiture (that is, an "order to terminate the merger" by selling shares or otherwise), or a fine. Procedures are being amended to bring them more in line with the EC's approach. The notification obligation will be based on the firms' turnover in the domestic or world-wide market. The revised law will set deadlines and provide for hearing from third parties in the administrative proceeding. It will also apply the merger law to efforts to obtain control through public bid, as well as through privately negotiated agreement (OECD CLP, 2000a, p. 4).

"Industrial policy" is not a factor in merger decisions, which are based only on net competitive effects. Possible economic benefits from a merger could be lower costs, economies of scale or scope, higher quality, increased exports, or greater competitiveness in foreign markets. The OPEC will inquire whether there is a less anti-competitive way to achieve these benefits. Approval may be conditioned on structural or behavioural restrictions [Art. 8a(2)]. In 1999, the OPEC imposed conditions on about 14% of the transactions it reviewed. Orders to maintain production or require access and to notify the OPEC of future changes appear common. For example, merging parties have been required to give all suppliers access to their distribution service, to maintain existing production for 5 years, or to keep local brands on sale for 5 years and "discuss with the OPEC" the potential sale of some assets. Conditions have not been based on price, though. Only one merger has been disapproved completely.

Several decisions approving mergers have promoted restructuring in traditionally monopolised industries. SPT Telecom's 1995 acquisition of Eurotel's data transmission operations was approved, even though Eurotel had a dominant position – indeed, a franchised monopoly – in public data networks, because the Ministry of Communications terminated Eurotel's exclusive licence and thus opened the possibility of entry. TelSource was permitted to acquire 27% of SPT Telecom, because the deal promised to improve service quality by meeting

unmet consumer demand, evidenced by long waiting lists. French and British water companies have been permitted to buy local water supply companies, because these strategic investors brought capital and know-how to improve equipment and improve consumer service. Although these acquisitions have been considered “horizontal” because the acquiring firms are in the same business, they did not actually compete in the same local geographic markets.

Some other high-profile transactions may also require competition policy oversight. The government is restructuring the electric power industry in preparation for privatising it. These transactions, particularly transfers to new owners, might be reviewed under the merger law. Removing the market share threshold from the law may give the OPEC more flexibility to approve such transactions, since there will no longer be a strong presumption against approving a transaction involving a firm with a market share over 30%. The OPEC participated in the drafting group that prepared the government’s restructuring plan, where it objected to the re-establishment of a monopoly through the distribution level. Having lost that argument in the drafting process, the OPEC is unlikely to disapprove these government-authorised transactions as they happen. The Revitalisation Agency is negotiating deals to restructure troubled firms. Presumably, many of these transactions will also need to be notified to the OPEC. There is a clear interest in re-organising these firms as quickly as possible. That may put some pressure on the OPEC to perform only a cursory competition review or to approve questionable transactions. To the extent the firms would otherwise fail and the assets exit the market, these concerns might be reduced. But it might also be prudent to involve the OPEC at the earliest opportunity, before commitments are made, in order to reduce the risk of pressure to approve financially attractive deals that could lead to market power.

The proposed amendments will substantially complete the process of making the Czech criteria for merger approval and processes for premerger notification conform to those of the EU (OECD CLP, 2000a, p. 4). The substantive rules will be generalised and the possibility of balancing competitive effects against other policy goals will be eliminated. The draft law would have included both a turnover measure (total turnover over CZK 400 million and of each entity over CZK 150 million) and market share test (aggregate of the merging firms over 25%), so that administration of the notification requirement would have depended on the uncertainties of market definition. The market share test was dropped from the notification criteria in the Act as it was finally adopted.

2.5. State aids

Subsidies and preferences can distort free competition and motivate otherwise unnecessary regulation. The OPEC has statutory responsibility to control anti-competitive state aids. Subsidies or preferences provided by the local or national

governments at all levels may not distort competition by favouring some firms or products. The OPEC has the authority to order firms to return the aid provided or to order the agency providing the aid to eliminate the competitive distortion. This responsibility was transferred from the Ministry of Finance as of May 2000. The EU's regular *Accession Partnership Report* had criticised weaknesses of the state aid office at the Ministry of Finance, which had only 4 staff (EC 1999, p. 66). The OPEC's new department for state aids has a staff of 16 lawyers and economists.

So far, the OPEC reports that the law is being respected, and that parties are notifying the OPEC and submitting applications for approval or exemption. The OPEC is trying to be as transparent in decisions as possible. It has issued guidelines and a booklet instructing how to stay within the law. The OPEC can, and typically does, apply conditions, such as requiring that aid must not exceed some percentage of costs. In the first year (from 1 May 2000 to 15 May 2001), the OPEC considered 140 state aid matters, refusing to permit the aid in 2 cases, approving it in 12, and imposing conditions in 88. (Administrative proceedings were terminated in the other 38.)

2.6. Public procurement

The OPEC also has statutory power to oversee the process of public procurement,⁹ reviewing objections raised by tenderers against actions of contracting authorities in award procedures. The OPEC does not substitute its own judgement about the quality of bids or awards, though. The OPEC can respond to complaints or initiate action on its own, and it can impose fines for material or repeated violations (OECD CLP, 2000a, p. 3). The OPEC has used consultations and seminars to educate officials about compliance. A draft law now being discussed by the Parliament will make the Czech rules fully compatible with EU requirements. The OPEC is trying to use information gained from its procurement responsibilities in its competition policy work. Bid rigging could violate both the competition law and the procurement law under certain conditions, such as if the grantor determined the "winner" before inviting bids or gave one bidder an unfair advantage in the process.

2.7. Unfair competition

The law of unfair competition can protect markets and the competitive process, or it can protect competitors in ways that make markets work less well. The Commercial Code prohibits conduct *contra bonos mores* ("against good morals") that could damage other firms or consumers. Redress for such acts of unfair competition must be sought through private suits in court. Examples listed in the statute include bribery, deceptive advertising and marketing, misleading consumers about identity, using another firm's reputation, disparaging competitors, violating trade secrets, and endangering consumer health or the environment. These rules overlap both competition policy and consumer protection.¹⁰

Advertising is also subject to direct regulation. This is largely self-regulation by the Arbitral Commission for Advertising, which applies the International Chamber of Commerce's 1986 Code of Ethical Rules in Advertising. A forthcoming amendment to the Commercial Code would permit comparative advertising (under specified conditions) and would bring the law into harmony with the EU Council directive about deceptive advertising. The consumer protection laws also prohibit deception and discrimination, as well as requiring proper and accurate information and controlling the sale of adulterated food products.

2.8. Consumer protection

The relationship between competition policy and consumer protection policy, concerning issues and tactics in the debate over regulatory reform, is reasonably well understood, but not well implemented. Consumer protection responsibilities are divided among several institutions. In the Ministry of Industry and Trade, there is a small (12 member) Consumer Protection department, which has been in place for 2 years. These institutions and the OPEC have occasions to co-operate with each other, but these arise infrequently.

Outside the government, there are several consumer groups, whose impact on the reform process has been modest. The Consumer Advisory Committee, established in April 2000, brings together 7 NGO consumer organisations. These include TEST, which tests products and publishes a magazine, the national Association for Consumer Protection (which operates information centres), and regional organisations. A Consumer Consulting and Advisory Service publishes consumer information on the internet. Another umbrella group, the Association of Consumer Organisations, was established in January 2001. The Consumer Advisory Committee is a vehicle for NGO organisations to promote their positions in policy and comment on legislation. The Committee was asked for comment on the government's consumer policy plans for the next several years, and it has been consulted about such issues as consumer credit and guarantees. But except for some issues of specific consumer interest, the effect of consumer organisations on the process has been slight. Consumer groups argued unsuccessfully for more rapid opening of the telecoms market, for example. They have tried to comment about utility pricing decisions, but comment is only possible at the earlier stage, at the Ministry of Industry and Trade, rather than at the more important final stage, at the Ministry of Finance.

3. Institutional Issues: Enforcement Structures and Practices

Successful reform of economic regulation can depend on vigorous action to prevent abuses in developing markets. The administrative approach to applying the Czech competition law has worked well in the past, but new tools are needed to deal with problems that the parties do not report to the authorities.

3.1. Competition policy institutions

The OPEC is the only body with the power to apply the Competition Act. The OPEC's chairman is appointed by the President, upon the proposal of the government.¹¹ The chairman may be dismissed by the same process, but only for causes that are specified in the law: bringing the OPEC into disrepute or impairing its independence or impartiality.¹² The appointment is for a 6 year term, which may be renewed once. The chairman must not be a member of a political party or movement. There is one director general who heads the antitrust section and one director who heads the merger department. Other staff sections deal with public procurement, state aids, legislation, and European integration and international issues. The chairman has a separate section which includes the economics department and a group that advises the chairman concerning "second-instance" decisions. This advisory group includes experts from outside the OPEC.

The OPEC was originally established in 1991. When it became a Ministry in 1992, headed by a member of a party in the governing coalition, the competition policy body gained an inside voice in important large-scale policy and structural decisions. The elevation of status demonstrated that competition policy was to be taken seriously. But being in the government may also have raised questions about the impartiality and independence of decisions, by suggesting that they might be subject to discussion and negotiation within the government. The fact that the law was later changed so that the chairman must not even be a member of a political party indicates that the problems of insider political access were adjudged to be greater than the benefits.

In 1996, the OPEC reverted to being an independent office. (The only other entity with similar status is the Czech Statistical Office.) The OPEC is fully independent of government or political control in its decision-making. Its status may make it more effectively independent than the sectoral regulatory bodies, because the OPEC has no ties to any ministry and the appointment is by the President, not a minister. Independence from the government is underlined by placing the OPEC's office in Brno, rather than Prague.

Transparent processes reinforce independence. At one time, the Ministry had a reputation for relatively opaque and infrequent formal decisions (Fingleton *et al.*, 1996; EC, 1999, p. 66), leading to criticisms about lack of transparency. Since then, the OPEC has made transparency in decision-making a high priority. Final decisions are published in the OPEC's *Collected Decisions* and are now posted quickly on its website.¹³ These decisions, which are formally similar to court judgments, still tend to be somewhat more conclusory than similar decisions in common law jurisdictions, which are more likely to discuss alternative arguments and explanations, as well as the basic reasons for the decision. To explain its policies and actions in more depth, the OPEC issues a regular report (by 30 May

each year), covering its activities and conditions in markets. This report is presented to the government. And to inform the public, the OPEC has issued guidelines about merger policies, and it is preparing guidelines on other topics. The OPEC (as well as other public agencies) must provide the public free access to information. As of 2001, OPEC compliance with freedom-of-information requirements will be a separate part of its annual report.

The OPEC has some formal contact with the policy-making process, but it is obviously less of an insider now than when it was a Ministry. The OPEC contributes to the work of government advisory bodies and *ad hoc* commissions about other policies. The OPEC chairman may attend meetings of Governmental Committee for European Integration (on his own request, or that of the Committee's chair). The OPEC's opinion must be sought by the Commission for Privatisation. The OPEC is consulted in the discussion and drafting of legislation, and OPEC staff participate in the working parties and drafting groups. Its authority to comment on the competitive implications of actions by other parts of the government is conferred by a government resolution,¹⁴ and its participation in the legislative drafting process is provided under the legislative rules.

3.2. Competition law enforcement

The Competition Act generally authorises the OPEC to enforce the law. It also sets out some procedures in more detail; to the extent it does not, OPEC proceedings follow the generally applicable Administrative Procedure Act.¹⁵ That code sets out sound basic principles, but it needs to be updated to deal with complex administrative processes and economic policy issues; a reform of this act is in preparation. The draft amendments to the Competition Act will improve some of the OPEC's procedures, but it will not revise them substantially.

The Competition Act provides generally that the OPEC can require firms to "provide materials and information necessary for the activities of the (OPEC)", and the OPEC can examine their "legal and commercial documents" to determine whether a violation has occurred [Art. 11(1i)]. Firms are required to provide requested materials and information punctually and in full, correct, and truthful form – and to permit the OPEC to verify that, by granting the OPEC access to facilities and premises to do so [Art. 12(5)]. The proposed amendments would add one legal protection to this process, by requiring the OPEC to state the legal grounds and purpose for its investigation when it requests documents and information. This proposal may be at least a partial response to the concerns expressed by some private practitioners about the need for preliminary procedures to narrow and define the scope of investigational demands.

The OPEC can take action in response to a request or complaint or on its own initiative. Enforcement actions against abuse of dominance or cartels are considered "own initiative" cases, even if they begin with a complaint from a victim. To

safeguard legitimate interests pending the final decision, and to preserve the possibility of enforcing a final order, the OPEC can issue interim, preliminary orders [Art. 12(7)].¹⁶ Oral hearings may be held at the OPEC's discretion. Whether or not there is a hearing, parties must have an opportunity to communicate their positions about the matter to the OPEC, to respond to the findings of the investigation and the action, if any, that the OPEC intends to take. A final decision must set out the legal basis for the decision, explain the justifications such as the supporting facts and the considerations applied to assessing the evidence, and instruct the parties how to appeal.

Decisions must be reached on a tight timetable. The deadlines for official action are taken from the administrative code. The normal period is 30 days, or up to 60 days for exceptionally complex cases. The chairman may extend the 60 day deadline if circumstances make meeting it impossible, but the parties must be informed about an extension and the reasons for it. For matters that are initiated by an application or request, the time runs from receipt of the request. For "own initiative" matters, the time runs from the OPEC's first action concerning the participants. Thus, the OPEC can take time to study a situation and determine whether action might be needed. The deadline clock would start running when the OPEC contacts the participants directly and demands information.

The basic fine for all kinds of substantive violations is the same: up to 10% of annual net turnover or CZK 10 million, whichever is greater. If the violator profited from the violation, the fine must be at least as great as that profit. For failure to provide requested information, the fine can be as high as CZK 300 000, and for failure to attend a hearing, CZK 100 000. Failure to comply with an OPEC order can result in a fine of up to CZK 1 million. All of these fines are levied directly by the OPEC, although the funds go to the general treasury, and not to the OPEC's own budget.

A disappointed party may appeal the initial decision within the OPEC, for a *de novo* assessment of the facts and the law.¹⁷ The OPEC notifies other parties when an appeal is filed and invites comment and, if necessary, more evidence. Parties may appeal the first-stage decision within 15 days to the chairman. The chairman decides the second-stage appeal, on the basis of a proposal from a special advisory board, which includes outside experts. The chairman may change or cancel the first-stage decision, reject the appeal and thus affirm the first-stage decision, or return the matter to the first-stage level for further investigation (in which case the first-stage decision is formally cancelled). Some practitioners have complained that internal appeal is not sufficient, because the chairman usually affirms the staff's decision. But the chairman has often disagreed with the staff's outcome and granted the appeal. In 1999 and 2000, out of 37 decisions appealed, the chairman affirmed only 19.

The next step for the disappointed party is to file petition for review by the High Court. The courts may review the OPEC's decision (including the result of internal appeal) for compliance with law, but the courts will not hear a full appeal on the merits of the evidence and the OPEC's reasoning. The number of petitions for review of second-stage decisions is declining; only 3 (out of 19 decisions) were filed in 1999. The High Court rejected one, and the others are still pending. No OPEC cases have been taken to the Constitutional Court for two years. The possibility of setting up specialised administrative courts, to hear full appeals on the merits of decisions by bodies like the OPEC, is under consideration. The constitution calls for a Supreme Administrative court, which has not yet been established. Changing the system to provide for judicial appeal will depend on other changes in the judicial system and on the availability of enough professional expertise.

3.3. Other enforcement methods

Private parties injured by violations of the Competition Act may sue in court for damages, disgorgement, and other monetary penalties, and for injunctions or orders voiding contracts (Art. 17). The statute tries to prevent claims from multiplying, by permitting only the first lawsuit filed about a violation to proceed. Other injured parties must join in that suit, rather than sue separately, and the decision will be binding against other with the same interests. (The special provisions in the Competition Act about private lawsuits are not included in the draft revisions, because equivalent relief is authorised under the generally applicable Civil Code, Commercial Code, and Civil Judicial Code.) Because only the OPEC has jurisdiction to determine whether conduct violates the prohibitions of the Competition Act, private actions depend upon the OPEC's establishing the predicate violation, such as the existence of dominance and abuse. Few private cases about competition law violations have been filed. One private suit among the parties to a contract raised the issue, whether the OEC would authorise what would otherwise be a prohibited agreement under the Competition Act.

The Czech Republic is adapting its law to that of the EU in anticipation of accession and the direct application of EU law to conduct in the country that has a community dimension. This process is guided by the "Europe Agreement", which entered into force 1 February 1995. When the EU treaty provisions become applicable, then the direct application of the competition policy prohibitions would support private suits in Czech courts.

3.4. International trade issues in competition policy and enforcement

Competition policy can play an important role in removing regulatory obstacles to competition from foreign producers. Czech competition policy has shown a commitment to trade liberalisation and a sensitivity about rules

inhibiting import competition. In merger review, among the barriers considered relevant are regulations that hinder imports or exports. After Skoda repeatedly increased prices, the competition agency in 1994 called for lower import duties so that foreign production could provide competition in the market. More recently, the OPEC advocated removing the Ministry of Transport's power to appoint a person to grant "foreign visas", because the party with that power was itself in the foreign road transport market and was thus regulating its competitors. The Czech Republic has entered several free-trade agreements: a customs union with Slovakia, the Europe Agreement, agreements with EFTA and CEFTA, and bilateral agreements with several countries. The OPEC has sought clauses in these agreements about protecting competition and prohibiting restrictive agreements and abuses.

Competition issues are sometimes raised in cases under the trade laws. The OPEC can participate in other proceedings under special acts, including the anti-dumping laws, where it may express its views about claims of damage and effects on competition from dumped imports and about proposed duties imposed in these cases. The Ministry of Industry of Trade is responsible for dumping determinations and orders, and in 2 or 3 cases it has asked the OPEC for its views. Most recently, the OPEC agreed with the October 2000 decision to impose dumping duties on table salt imported from Germany.

An "effects" test is applied [Art. 2(3)], so the Czech competition law may apply to conduct outside the country's borders if it affects domestic markets. Foreign mergers must be notified if they meet this "effects" test. Some of those transactions have produced significant OPEC decisions, notably the recent decision approving, with conditions, an acquisition by a major foreign beer producer.

Co-operation with competition agencies in other jurisdictions has increased, particularly with the EU and colleagues in Slovakia, Sweden, France, the Netherlands, and the UK. The OPEC has worked with the EC Competition Directorate on several occasions, notifying the Commission 2 times about cases in progress to co-ordinate common decisions and to inform about acquisitions that may have had Europe-wide impacts. The rules implementing the Europe Agreement specify what kinds of cases will be considered, the principles applied, the bodies competent to discuss them, and how confidential information will be protected. In general, the OPEC cannot share confidential information. But it does exchange non-confidential information about firms and industry conditions, market definitions, and other particular issues. Bilateral co-operation agreements have been signed with Russia, Bulgaria, Romania, and Ukraine, calling for exchanging personnel, sharing views about legal issues, scholarships for experts, and consultation on particular cases.

3.5. Agency resources, actions, and implied priorities

Budget and staff resources for competition policy have been adequate, and are increasing as responsibilities are added. Staff levels have held steady for several years, at about 90. Staff increases in 1999 and 2000 – and a 60% budget increase in 2000 – are due to new responsibilities related to EU accession, over state aids and procurement, and to strengthening efforts to punish more serious violations by setting up a new cartel department. (The disproportionate budget increase in 2000 is due principally to one-time costs of setting up the state aids office.) The proportion of professionals (lawyers and economists in nearly equal numbers, and a smaller number of others) on the staff is increasing, from about 75% of the total in 1997 to over 85% now. The number of staff devoted to advocacy, regularly and *ad hoc* for particular matters, is also increasing, drawing as needed on sector experts and on the legislative, fundamental issues, and European integration and international departments. There is no separate, dedicated section of the staff for advocacy. The state aids and procurement responsibilities occupy over 40% of the OPEC's professional staff resources. The procurement workload appears to be increasing substantially, as the number of administrative proceedings increased 30% between 1998 and 1999, to nearly 600, and the number of cases imposing fines doubled, to nearly 60.

Like other offices in the Czech state administration, the OPEC has suffered some turnover and losses, as staff have left for more attractive opportunities in the private sector. Turnover slowed some from 1997-99, and the proposed new act on civil service may lead to more stability. The OPEC is trying to find ways to get people to stay the year it takes to learn how to do the job. But the budget limits what it can offer in pay. As part of the state administration, the OPEC must set compensation and other terms to be consistent with other public sector salaries and work within the standard recruitment process. The OPEC has tried to use bonuses, although not up to the 100% level that is theoretically authorised. Sometimes the OPEC must “outsource” for quality analysis, turning to law professors for help with drafting and consulting outside experts about unfamiliar questions of technology (Tables 1 and 2).

The higher priority now given to hard core cartels does not yet appear in the enforcement record. Horizontal price fixing accounted for only 3 cases in 1999, while there were 7 about resale price maintenance. The largest fines appear to apply in cases of abuse of dominance. In 1999, abuse of dominance cases accounted for nearly a third of the fines – CZK 10 million out of total fines of about CZK 36 million.

Cartel cases decreased from 1996 to 1997, as actions against professional associations declined. The trend turned upward again in 1999, when the OPEC set up a cartel department. Increasing numbers of franchise applications in 1997-98 led to

Table 1. Trends in resources

	Person-years ¹	Staff turnover	Budget (CZK)
2000 ²	110		63 011 000
1999	88	17.0	37 835 000
1998	86	19.8	35 397 000
1997	90	20.0	34 571 000
1996	88	22.7	35 386 000
1995	80	13.8	29 424 000

1. Includes personnel responsible for public procurement and, for 2000, state aids.

2. Estimate based on first six months (106 person-years), and personnel level of 120 authorised by law in March 2000; budget is planned expenses for the year.

Source: OPEC, 2000.

Table 2. Disposition of professional personnel

	Competition Act	Public procurement	State aids ¹
2000 ²	61 ³	36	15
1999	47	21	14
1998	44	16	
1997	42	13	

1. Since 1 December 1999.

2. All personnel, including non-professionals.

3. Of this total, 11 are in the Legal department and the European integration and international department, which also deal with some state aid and public procurement issues.

Source: OPEC, 2000.

the March 2000 “block exemption” decree, to deal with them systematically. Most actions against abuse of dominance – in 1996, 82% of them – concerned regional and local utility monopolies, and they usually targeted the same practice, of trying to hold up new customers with demands for extra payments. That conduct declined after repeated OPEC intervention. Restructuring of firms that had been strongly dominant may also explain the decline in abuse of dominance cases. But more attention to natural monopolies again in 1999 meant more cases. Mergers peaked in 1993, most of them actions representing foreign firms acquiring Czech firms, and again in 1996, as Czech firms began combining more with each other. The decline since then reflects the completion of most of the privatisation process (Table 3).

The OPEC’s top priority is, of course, enforcing the law generally and promoting competition by removing barriers to market liberalisation and consumer welfare. The OPEC also wants to ensure fair treatment of foreign investors in merger reviews, in order to encourage foreign direct investment. Introduction of competition in natural monopoly areas is also a matter for attention.¹⁸

Table 3. Trends in competition policy actions

	Horizontal agreements	Vertical agreements	Abuse of dominance	Mergers
2000: ¹ matters opened ²	4	20	4	36
Sanctions or orders sought ³	2	15	2	3
Orders or sanctions imposed ⁴	1	5	2	0
Total sanctions imposed ⁵	7 800 000	1 650 000	11 000 000	–
1999: matters opened ²	16	48	14	54
Sanctions or orders sought ³	13	45	9	7
Orders or sanctions imposed ⁴	7	13	9	0
Total sanctions imposed ⁵	10 400 000	1 465 000	23 090 000	–
1998: matters opened ²	10	73	5	58
Sanctions or orders sought ³	6	65	3	11
Orders or sanctions imposed ⁴	3	8	3	2
Total sanctions imposed ⁵	600 000	2 230 000	2 100 000	–
1997: matters opened ²	10	35	10	61
Sanctions or orders sought ³	7	30	6	6
Orders or sanctions imposed ⁴	3	13	6	2
Total sanctions imposed ⁵	20 000	4 920 000	1 550 000	–
1996: matters opened ²	15	16	29	75
Sanctions or orders sought ³	7	10	17	5
Orders or sanctions imposed ⁴	7	3	17	1
Total sanctions imposed ⁵	13 670 000	2 770 000	31 185 000	–
1995: matters opened ²	20	12	32	58
Sanctions or orders sought ³	18	6	18	1
Orders or sanctions imposed ⁴	12	2	18	1
Total sanctions imposed ⁵	2 504 000	100 000	18 698 000	–

1. First 6 months.

2. Open cases, including cases extending to the following year, cases investigated in the particular year but discontinued, and closed cases.

3. Agreements include those authorised (sometimes with conditions), prohibited, and fined. Mergers include those authorised subject to conditions.

4. Agreements prohibited and fined and mergers disapproved.

5. Amounts are in CZK. Fines ordered in the reported year, not necessarily those collected. Fines only include fines for substantive violations, not fines to enforce compliance with procedures.

Source: OPEC, 2000.

By sector, the largest number of competition policy enforcement actions has been in the food industry, where there is a trend toward higher concentration and an increase in franchising, followed by tyres, where many franchise agreements have been reviewed. By far the largest number of horizontal agreement cases have been in professional services, but these have declined recently. Another area of significant activity has been electric power and gas (Table 4).

The number of proceedings rose sharply (74%) from 1998 to 1999. But the number of appeals declined just as sharply. Internal appeals from first-instance decisions dropped 46%, and petitions for court review of the chairman's decisions dropped 90% (Table 5).

Table 4. **Competition Act actions by sector (1995-1999)**

Sector	Agreement		Abuse of dominance	Merger	Total
	Horizontal	Vertical			
Food products	6	49	6	30	91
Tyres		36		7	43
Electricity and gas		12	16	10	38
Tools and mechanical equipment	1		1	30	32
Professional services	21	3	1	5	30
Steel and metals	2	1		25	28
Public utilities			4	23	27
Distribution	8	13	1	4	26
Chemicals		5		20	25
Others services	1	1	5	15	22
Electronic machinery	1	5		13	19
Mineral processing, non-metal	1	4	1	13	19
Oil and petroleum	2	7		6	15
Glass		5		10	15
Telecommunications	2	1	6	5	14
Paper	2			11	13
Banking and Insurance		1	6	3	10
Vehicles and planes		1	2	7	10
Transport and related activities	2		3	4	9
Civil engineering	1	1		5	7
Furniture		7			7
Publishing		3		3	6
Pharmaceuticals				5	5
Sport, culture		1		2	3
Postal services			1	2	3
Textiles and clothing				2	2
Internet	1				1

Source: OPEC, 2000.

4. Limits of Competition Policy: Exemptions and Special Regulatory Regimes

4.1. Economy-wide exemptions or special treatments

Czech competition policy applies generally, containing no specific exemptions for sectors or types of enterprises, and only a limited general provision for subordinating competition policy to other regulations. Thus the law provides a sound framework for broad-based regulatory reform.

The Competition Act contains few provisions that imply any exclusion or exemption from it. There is no exemption for particular kinds of institutions or entities; rather, competition policy applies to all kinds of entities that may be engaged in market competition, whether or not they would be considered

Table 5. Structure of decisions issued in 1999¹

	Number of proceedings		Number of proceedings	Percentage of proceedings
Existence of regulation	118	Regulated sector	19	16.1
		Unregulated sector	99	83.9
Ownership of entities involved	Of the 210 participants in these 118 proceedings	Private ownership	189	90.0
		State majority	15	7.1
		Municipal majority	6	2.9
	Of 62 companies in 51 merger proceedings	Private ownership	52	83.9
		State majority	4	6.5
		Municipal majority	6	9.6
Agreements distorting competition	54	Price fixing	3	5.6
		Resale price maintenance	7	12.9
		Market division	1	1.9
		Miscellaneous	43	79.6
	Of the 43 "miscellaneous" agreements	Franchise	19	44.2
		Exclusive sale	6	14.0
		Exclusive purchase	8	18.6
		Rationalisation	8	18.6
		Exceptions under Art. 5	2	4.6
Abuse of dominant position	13 (7 in regulated areas)	Refusal to supply	4	30.8
		Discrimination	4	30.8
		Inappropriate conditions	1	7.6
		Miscellaneous	4	30.8
Market share (for mergers and abuse of dominant position) ²	Distribution by market share of 51 analyses (64 cases in total)	30-50%	18	35.3
		50-70%	11	21.6
		70-100%	22	43.1 ³

1. Cases overlapping into the following year and cases that were discontinued without final decision are not included.

2. Where a proceeding involves several markets, it is counted here under the largest market share.

3. Mostly administrative and local monopolies.

Source: OPEC, 2000.

businesses. Agreements that would otherwise be prohibited may be allowed if they are authorised by separate regulation [Art. 3(1)]. The section of the Act prohibiting abuse of dominance does not contain any similar explicit provision, but a similar principle applies, most often in the context of natural monopolies subject to special regulatory laws and agencies. Such laws, or decisions of those agencies, can regulate behaviour in a way that restricts the scope of the Competition Act's prohibitions. There are few clear rules about the relationship between these special regimes and the general competition law. One clear principle has been established: competition policy can prohibit abusive conduct that exceeds what the special law or regulation actually authorised. Special legislation that effectively exempts some conduct by a firm does not exempt everything else that

the firm does. An example is a recent case¹⁹ which found that a gas company abused its monopoly position by charging customers a fee for installing gas meters, when the Energy Act required the company to install meters at its own expense.

The amended law will make clear that the Competition Act applies to public firms and to those granted special and exclusive rights by law to provide services of general economic interest. The language will follow Art. 86 of the EU treaty. This would represent a clarification, not a change in the Czech law. The amendment would make it explicit that the competition law would not apply only to the extent that applying it would prevent provision of “universal” services, those that must be provided widely, reliably, and at a reasonable price.

Not only are public enterprises fully covered by the law's prohibitions, but government bodies are under a statutory obligation not to impair competition. Agencies of the national government and local government administrative bodies may not restrict or eliminate competition, either in their own provision of services or by special support for favoured firms (Art. 18). The OPEC can investigate and call on the government body to correct the problem. But the OPEC cannot order mandatory corrections or sanctions.

The new law will delete Art. 18, leaving the actions of local officials governed only by the new article about services of general economic interest, modelled on Art. 86 of the EU treaty. In the inter-ministerial drafting process, other participants on the legislative committee argued that the Art. 18 rule was inconsistent with standards of quality drafting because there was no process or sanction for dealing with breach. The OPEC intends to see how the new draft law works in practice, and if municipalities misbehave, they will propose another change. So far, most municipalities have complied with the OPEC's requests even in the absence of sanctions. But not all have gone along: when the OPEC called on three cities to eliminate their anti-competitive controls on entry into the taxicab business, two of them complied, but the third refused. Repealing Art. 18 may undermine or even eliminate the OPEC's power to investigate problems and recommend changes, unless those functions are included in a general advocacy authority to study competitive conditions and make recommendations about them. Repealing Art. 18 may send the wrong signal to local governments. Municipal governments have several kinds of opportunities to take actions that could impair or distort competition, and the new regional bodies that are now being established may also have similar opportunities.

Municipalities have statutory powers to provide some services, including waste collection and disposal and water supply and treatment, or to provide for them, such as for housing, transport, communications, education, public order, and social security. Localities can own infrastructure networks, by holding equity

stakes in companies, or they may select operators through long term contracts. The locality assumes the role of regulator, for functions within its statutory powers. Some actions, such as long-term exclusive contracts with network operators or controls on competitive entry through zoning decisions or licensing methods, might violate the Competition Act, if the actions were not authorised by special laws about municipal services.

Water and sewer charges are regulated Community waste disposal is entirely under the municipalities' control, and there is no provision for regulating the price for this service, which is set by the municipal government. The OPEC has contended that the statute authorising municipal waste disposal service should provide some means of controlling abusive prices. Management of solid waste is essentially competitive, although local governments can control the location and operation of dumps. The OPEC rejected a complaint against a local rule requiring all collectors to use a single dump. By law the waste "belongs" to the municipality, and it can do with it what it wants.

Municipalities have tried to use their powers to favour their commercial interests. They have refused zoning permission to build gas boilers in new buildings, instead requiring that the projects be hooked up to the heating companies in which the cities had interests. The OPEC has intervened under Art. 18 to create arrangements that would allow the new projects to use gas heating. And sometimes municipalities have tried to demand measures unrelated to providing services. The OPEC found that one such effort, to demand a lump-sum payment in exchange for access to the water and sewer systems, was an abuse of dominance. The High Court upheld the OPEC's order, finding that this exercise of market power was not excused by being part of the municipality's scheme for fulfilling its service obligations.²⁰

Small and medium sized business do not receive special treatment or consideration. The *de minimis* principle generally exempts agreements among firms with small market shares. But this principle does not necessarily depend on the size of the firm (although smaller firms are probably more likely to have smaller market shares). And the point of the rule is not to shield anti-competitive behaviour, but to save costs by identifying and excluding from enforcement attention behaviour that is not likely to be anti-competitive. Now, the *de minimis* rule applies to agreements among firms whose collective national market share is below 5%, or whose local market share is below 30% [Art. 3(4c)]. Markets where firms appear to take advantage of the *de minimis* rule frequently include tyre sales, fast food, and bottled gas. The *de minimis* exemption is not available for agreements to fix prices or divide markets. The new law will modify the rule to conform to the EC's *de minimis* rule, setting a 5% market share threshold for horizontal agreements and 10% for vertical agreements, which will be directly applicable, with no filing or approval process. The rule will not exempt horizontal price fixing or market

division, resale price maintenance, absolute territorial protections, or agreements whose cumulative effect is significantly anti-competitive. Executive decrees will also establish market-share-based block exemptions, which may tend to exempt the conduct of smaller firms.

4.2. *Sector-specific exclusions, rules and exemptions*

No sectors are fully exempted from the Competition Act, and provisions for sectoral regulation do not exempt regulated firms from the law generally. Regulated electric power distributors objected to an OPEC action against them for abuse of dominance, but the High Court found that a monopoly position is defined without reference to regulatory structure and that the law applies despite the regulation.²¹

The OPEC has supported the creation of sectoral regulators for traditional natural monopoly sectors, believing that regulation is needed both to ensure proper conduct and to assure foreign investors that the regulatory system is effective and predictable. In 1998, the OPEC suggested that there should be a memorandum of understanding to govern co-operation and consultation between the OPEC and newly created independent regulatory bodies. Although the ministries made no formal response to the OPEC's proposal, it nonetheless had an impact, as those ministries have moved to establish independent regulators, whose powers are set out in separate laws. The OPEC and the telecoms regulator have established a close relationship based on a memorandum of co-operation, which was signed in January 2001 by representatives of the two institutions. The two bodies will consult about cases that come under the jurisdiction of both offices, exchange information about applications, and co-operate about legislation. The possibility of a similar agreement with the newly established Energy Regulatory Office is under consideration.

4.2.1. *Insurance*

The statute that liberalised auto liability insurance in 1999 provides for a three-year transition period of minimum and maximum price controls. This service was a monopoly until 2000, when about a dozen firms began offering policies. Controlling prices distorts incentives and prevents normal market forces from operating freely. But there was concern that firms would try to claim market share by aggressive low pricing. It is not clear whether the basis for this concern was that the firms would jeopardise their own solvency, or whether this competition would weaken the former monopolist. The OPEC recommended that maximum prices also be set during this transition period, to protect against the exercise of market power. In other respects, the Competition Act applies fully in the insurance sector.

4.2.2. *Transport*

Entry into the domestic trucking industry is generally open. Licences are required, but there are no quantitative limits and incumbents may not object to licensing new entrants. The trucking industry has expanded strongly in the competitive environment of the 1990s, in part at the expense of the rail sector. But international trucking services, which are subject to bilateral intergovernmental agreements controlling entry and cabotage, are less competitive. Entry into taxicab services is also open, although municipalities may impose fare caps. In bus services, some municipalities have moved to create competition with the traditional monopoly provider and improve services to remote areas. Transport issues are dealt with in more detail, particularly concerning trucks and railroads, in Chapter 6 of this review.

4.2.3. *Broadcasting and other media*

Regulation of entry and cross-ownership in television and radio broadcasting is intended primarily to ensure against dominance. It is not clear whether the concern is to preserve viewpoint diversity or to prevent media conglomerates from gaining large market shares. The Council for Radio and TV Broadcasting allocates spectrum and grants licenses for radio and TV broadcasting. Licence holders must comply with regulations concerning the length and placement of advertisements and with some public interest obligations, such as reflecting the plurality of opinion, supporting the cultural identity of ethnic groups, and providing closed-caption broadcasts for the deaf. Satellite and cable service providers need only register with the Council; no license is needed, and there is limited room for the Council to impose conditions on their program content.

The OPEC has advocated legislation to prevent cross-ownership between different media. The OPEC's policy concerns in this sector are to prevent dominance and ensure competition in advertising markets, multiplicity of viewpoints, and transparency of ownership relationships. OPEC officials are on a commission established by the Ministry of Culture to prepare a new radio and TV broadcasting act, which would prohibit connections between radio and TV broadcasters and publishers of national periodicals and in other ways support plurality of information and transparency of ownership relations. There are no special rules about concentration of ownership in any single medium. The general standards about measuring dominance might apply, but occasions for doing so are not evident. Because licences are technically not transferable, the OPEC may have few occasions to analyse a merger among broadcasters.

4.2.4. *Postal services*

Legislation adopted in 2000 sets out a framework for liberalisation of postal services. The historic provider, Czech Post, will retain the monopoly as the only

licensed provider of letter and small package (under 350 grams) delivery services. As of 2003, there will be a tender for 20 year licences for these services, which will be subject to universal service obligations. Licences will be issued by the Ministry of Transport and Communications. Prices are controlled only by price caps, administered by the Ministry of Finance. Entry into other package delivery and courier services is open.

4.2.5. Professional services

Professional associations control entry and practice in many sectors, such as medical care, law, accounting, engineering, and architecture. This self-regulation generally monitors compliance with professional qualifications and quality of service. The OPEC has tried to challenge anti-competitive self-regulatory controls, particularly those that constrain pricing freedom or that limit entry more than would be reasonable to ensure quality. Professions claim that their authorising legislation amounts to special regulations permitting derogation from the Competition Act; however, the High Court has held that the Competition Act also applies to firms whose activities are governed by special legal regulations.²² Even after the OPEC's enforcement efforts, some controversies about price lists continue, particularly in the property-related professions such as assessors, architects, and contractors. The OPEC sued to block the architect's minimum fee schedule, and the order was affirmed in court. Some of the associations' membership controls still appear potentially discriminatory. The notaries' long training period and high admission fee suggest that they have tried even harder than others to prevent entry.

Pharmacists have presented several problems. The OPEC successfully challenged the professional association's effort to control the number of pharmacies in individual municipalities. It also objected to discriminatory controls on entry. The association required a separate approval to operate a pharmacy. An individual or firm that was not a licensed pharmacist would of course be required to hire a licensed pharmacist in order to operate the pharmacy – and the non-pharmacist would have to pay CZK 1 000 000 for that operating privilege, while a licensed pharmacist would only pay CZK 1 000. In addition, the association imposed stricter requirements, of experience and education, for a pharmacist to work in a pharmacy owned by a non-pharmacist. The result, and no doubt the intent, was to make it difficult for non-pharmacy firms to get into the sector. The OPEC's order to stop these restraints was affirmed.²³ (Pharmacy margins, like drug prices generally, are controlled by ceilings set by the Ministry of Finance, as an element in the national program of obligatory publicly-provided health insurance and coverage) (Table 6).

Table 6. Self-regulation by professional associations

	Requirements for entry				Association- issued price list
	Citizenship	Permanent residence	Experience (years)	Application fee (CZK)	
Doctors	No ¹	Yes ²	3	500-1 500	No
Pharmacists	Yes ¹	Yes ²	5 ³	1 200-4 000	No
Lawyers	No	No	3	6 000	No
Architects	Yes	Yes	3-6	6 000	Yes
Engineers	Yes	Yes	3-6; 8	2 500	Yes
Auditors	No	No	2	2 600-15 000	No
Tax advisors	No	No	No	4 000	No
Notaries	Yes	No	5	30 000	No ⁴

1. The Ministry of Health Care can accept foreign education.

2. Inferred from the application form, which requires a statement of permanent residency.

3. For the responsible representative.

4. Fees are set by the Ministry of Justice.

Source: OPEC, 2000.

5. Competition Advocacy for Regulatory Reform

Promoting the principles of competition in the restructuring of the Czech economy and regulatory system has been an important function from the outset. This has been done not just by offering advice, but also by direct participation in key restructuring decisions. During the critical period of the mid-1990s, the OPEC (then a Ministry) had representatives on the supervisory boards and boards of directors of strategic plants and enterprises, such as SPT Telecom, Czech Railways, and the First Newspaper Distribution Company. From those positions, it could press for competition policy goals in fundamental decisions about privatising and restructuring. More recently, the OPEC was represented on the commission that selected bidders for GSM telecoms licences. One goal was to ensure that fixed-line operators did not participate in the auction for this potentially competing service (Box).

Efforts to create special exemptions from general competition policy have generally been resisted successfully. The OPEC objected to a proposal to exempt the entire agriculture sector, and to another that would exempt all agreements about copyright royalties. It succeeded in preventing the adoption of a statutory exemption for resale price maintenance that was sought by the association of booksellers and publishers. Advocacy has also helped design regulations to avoid competitive problems or help markets work better. In health care, the OPEC suggested more transparency, or encouragement for new entrants, to correct

Advocacy to counter abuse of dominance: insurance

In the early 1990s, the provider of auto insurance increased premiums sharply, contending that the increases were needed to cover equally severe losses. Consumers complained that the premium hikes were an abuse of its dominant, indeed monopoly, position. Rather than simply take action against the firm under the Competition Act, the OPEC studied the situation in more depth and investigated the approaches that insurance firms were taking in other countries. The OPEC recommended regulatory and operational changes to reduce losses and increase efficiency, such as surcharges, higher deductible amounts, division of risks, and tailoring policies to individual risks, among others. The insurance regulator, prodded by the government, instructed the insurance company to adopt the OPEC's proposals to reduce losses. Premiums declined 20%.

Source: OPEC, 2000.

proposed rules that favoured incumbents in a way that could have left no room for new entry. And the OPEC has supported legislation to set uniform terms for returnable packaging.

Other parts of the government support competition policy goals. One of the most significant is the Ministry of Finance. The Ministry sets prices in the sectors, mostly utility services, where prices are still controlled. The Ministry must consider how price structures affect barriers to markets and promote market-based arrangements where competition is still limited. The Ministry tries to promote market institutions in its enterprise sector financing program, and to avoid distortions of competitive markets in setting tax policies. And it undertakes to promote market principles in financing health and social security programs.

The Legislative Rules require that all draft bills and decrees must be presented to the OPEC, so that it has an opportunity to comment in the inter-ministerial commentary procedure. A government decree authorises the OPEC to assess and comment on other government actions that could affect competition, such as decisions, "conceptual" policy proposals, administrative and municipal decisions, and privatisation proposals. The OPEC need not wait for a request for its views. It can and does offer advice on its own initiative, often based on its findings in other activities. The OPEC has always tried to be involved at the earliest stage, because it may not be possible to fix problems later on, as the OPEC could not overturn a government decision. Despite the formal authority, there is no guarantee of OPEC involvement and consultation. The OPEC has to take the initiative to be sure its views are heard.

Advocacy extends beyond the intra-government process, as the OPEC is occasionally invited to explain its positions to Parliamentary committees. Sometimes the OPEC takes positions about amendments being offered in the legislature, objecting to proposals that would weaken a program, or calling for changes to improve or correct problems in the government draft.

Advocacy has succeeded in 36% of the “major” situations, according to the OPEC. This figure reflects adoption of the OPEC position in proceedings at the level of the national government, and does not include advocacy involving local government issues. That rate is comparable to the success rates reported in several other jurisdictions that have tried to track this, notably Italy and Denmark. It is lower than the rate reported in Korea, where the competition agency enjoys more direct access to the policy process. Advocacy activity in the Czech Republic increased after the agency’s status changed from being a Ministry to being an independent office again. It may be that the Ministry could perform the advocacy function less formally and visibly, in intra-government debate and through direct action as a member of many boards of directors. Also at about the time that the status changed, there was an upsurge in enforcement about problems often subject to advocacy: professional services, cable TV, and actions by government bodies.

Advocacy has concentrated on sectors characterised by utility-service monopoly or self-regulatory controls. Most advocacy has been in utility sectors – power, water and sewer, telecoms, transport – corresponding to and supporting trends toward liberalisation. A series of papers since 1994 has supported electric power reform and the establishment of a regulatory structure in advance of privatisation, as well as separating power generation from transmission and distribution; however, the OPEC did not persuade the government to maintain vertical separation in the privatisation plan. The OPEC has called for separating rail infrastructure from rail operation and for financial and accounting separation between railways and non-rail operations. In telecoms, the OPEC tried to ensure that the new GSM 1800 operator would not have ties to current fixed or mobile operators. In postal services, the OPEC called for limiting the incumbent’s monopoly term. In water and sewer service, the OPEC recommended clearer rules about the source of project funding for public companies (Table 7).

Enforcement experience has sometimes supported advocacy and regulatory solutions. Frequent proceedings about abuse of dominance by local cable TV monopolies have led to proposals to regulate prices in that sector, for example. After numerous complaints about professional services, the OPEC helped rewrite the basic legislation in 1994, taking the position that giving associations exclusive rights to control entry (by requiring practitioners to be members) could be anti-competitive. The subject of anti-competitive professional regulation is perennial,

Table 7. Competition advocacy interventions

	1993	1994	1995	1996	1997	1998	1999	Total
Electricity sector		1	3	1	2	2	3	12
Professional services		1	2		2	1		6
Public utilities		1		1		3	1	6
Telecommunications			2		1	2	1	6
Gas industry		1		2		1	1	5
Road transport		1				1	3	5
Banking and insurance	1	1		2				4
Foods			1	1	2			4
Oil			1			3		4
Health insurance		1			1		1	3
Mining					1	2		3
Publishing, newspapers	1	1			1			3
Tourism					2	1		3
Cable TV				1	1			2
Ceramics				1		1		2
Chemical industry						1	1	2
Motor vehicles		1		1				2
Pharmaceutical industry						1	1	2
Postal services						1	1	2
Railway transport							2	2
Retail distribution			1				1	2
Security services							2	2
Taxi service					1		1	2
Waste management						1	1	2
Airports						1		1
Collection of laws					1			1
Companies register					1			1
Copyrights							1	1
Entertainment				1				1
Estate agencies				1				1
Export promotion policy				1				1
Health care							1	1
Need for independent regulators						1		1
Privatisation policy						1		1
Returnable packaging							1	1
Steel				1				1
Tobacco							1	1
Trade licensing							1	1
Wood processing			1					1
Total	2	9	11	14	16	24	25	101

Source: OPEC, 2000.

Table 8. **Competition policy enforcement linked to competition advocacy**

	1993	1994	1995	1996	1997	1998	1999	Total
Professional services			7	3	2			12
Cable TV			1		7	1		9
Electricity sector	2		2	3			1	8
Public utilities	2	1			2	1		6
Actions of state and local authorities			6					6
Gas industry			1	1			1	3
Health insurance			1				1	2
Taxi service	1	1						2
Banking and insurance			1					1
Road transport				1				1
Telecommunications							1	1
Total	0	5	6	17	15	4	4	51

Source: OPEC, 2000.

though. The OPEC has argued against a draft law requiring interpreters to leave the practice at age 65, saying that instead competency evaluation should be individual, and against shifting power over qualifications, examinations, and entry from the Ministry of Finance to the associations of auditors and tax consultants (Table 8).

6. Conclusions and Policy Options

6.1. *Competition policy institutions are sound, and help point the way to dealing with other issues*

In reorganising its institutions over the last decade, the Czech Republic has been able to avoid most anti-competitive economic regulations and to establish competition policy laws and institutions that support the substantive and process goals of reform. The more important remaining challenge to improving the competitiveness of the Czech economy is improving the institutions of corporate governance and finance, not those of competition policy. Competition policy's foundations and goals, to encourage dynamic adaptability and consumer welfare, show the direction that solutions to those other problems should take, although the institutional tools of competition policy are not well suited to resolving those problems directly.

Competition policy and principles apply generally throughout the economy. There are no significant or unusual exemptions or exclusions from coverage. The process for accommodating special legislation that derogates to some extent from competition policy seems to work well, and the scope of such special legislation is modest. The principal remaining area of controversy, professional services, calls

for balancing divergent consumer interests in ensuring quality service and in preventing the exercise of market power. The judicious combination of law enforcement with advocacy and regulatory reform – and continuing vigilance – is the best that can be done in this commonly encountered situation.

Sensible applications of competition policy reflect realistic priorities. After the introductory period, of clearing up rules about vertical restraints as market-based distribution systems were established, disciplining abuses of dominance, mostly by utility firms, and correcting anti-competitive self-regulation, attention is now turning to the more difficult problem of horizontal cartels. From the outset, the OPEC has calibrated its actions to the likely injury from different types of violations, concentrating the heaviest fire on collusion and monopoly. Although the number of decisions about horizontal agreements has been smaller, so far, than about vertical agreements, the severity of the sanctions imposed for violations has been 4 times greater, averaging over CZK 1 million per horizontal violation. The most recent fine in a horizontal cartel case was CZK 7.8 million. The average sanction for abuse of dominance violations has been about CZK 1.6 million.

Competition policy institutions appear well adapted to their conditions. Institutional independence has become clearer, now that the OPEC is no longer a Ministry in the government. The early experiment of granting full ministerial status to competition policy was probably appropriate at that stage. It ensured high-level direct access to decision-making during a critical period of the economic transformation. The shift back to an independent “office” since then may be better for an agency whose principal task is law enforcement. There is no doubt about its decision-making independence. Not only is this provided formally by statute, but the history of stability in leadership at the OPEC (and the Ministry) confirms it.

Formal independence does not necessarily mean that the OPEC is oblivious to the government’s policies or to potential ramifications of its decisions. In theory, for example, the OPEC may have the power to take an independent decision about an acquisition implementing a privatisation decision, and even disapprove it on competition grounds. But the OPEC is highly unlikely to reject a formal, final government decision; that is why it prefers to submit its opinions about privatisation proposals early in the process, before those decisions are made. And some observers find that decisions about mergers may respond to publicly raised concerns outside of competition policy.

Independence and distance from the government may tend to weaken the voice of competition policy in the policy process, though. Overall, the advocacy “success” rate is average. The OPEC will need to make the most of its reputation for solid, dispassionate professionalism and enforcement as a basis for public argument and advocacy, to ensure that competition policy is taken seriously in policy-making.

Practitioners who deal with the OPEC regularly find it to be prompt and professional, conscientious and thorough, and improving its analysis as it gains experience. Transparency is no longer a significant concern, as decisions are appearing promptly on the internet, although some practitioners have observed that the reasons for decisions are sometimes unclear. For example, decisions do not always explain the reasons why markets are defined one way rather than another.

Co-ordinating competition policy with other regulatory programs seems not to have raised major problems yet. In financial services, for example, the OPEC consults where appropriate with the prudential regulator (the Czech National Bank), which must approve substantial changes in holdings of banks' shares. The OPEC has permitted bank consolidations to improve efficiency, while it has also investigated banks for possible co-ordination about fees. Independent regulators are just being established for liberalising infrastructure sectors, so experience is limited and relationships are not formalised.

6.2. Capacities for and impediments to change

Much of the reform program is energised and driven by the EU accession process, guided by the Europe Agreement. In competition policy, some adjustments in details of law and process will conform Czech law better to the *acquis communautaire*. These changes are anticipated to be effective by mid-2001.

The integration of competition policy into regulation proceeds along several paths. Not only does the competition law apply to regulated sectors, but the revised law should provide a particularly useful additional tool for doing so. The draft amendments will make it clear that denial of access to an infrastructure network, which is a common controversy in liberalising sectors, is a competition policy problem, not just a regulatory technicality. Already, there is a substantial history of applying the competition law to abuses by infrastructure firms. One feature of the law remains in reserve, namely the power to order restructuring to correct repeated abuses. Instead, restructuring is being done through legislation. Restructuring as a result of law enforcement is a strong step, one that is not often taken in any jurisdiction. Disuse may make this theoretical power irrelevant, though.

Co-ordination through the policy process is equally important. The OPEC is a member of the *ad hoc* interdepartmental working group on regulatory reform, which was created in August 2000 to co-ordinate work on this OECD study. This body could become the agency for more systematic, permanent horizontal oversight of regulatory quality, including its effects on competition. This could be timely, for there are signs that competition policy issues are not getting the attention they deserve elsewhere in the government. A key element of the competition policy

advice was disregarded in the plan to restructure the electric power sector. The OPEC is unlikely to use its legal power of merger control to stand in the way of implementing the restructuring plans, despite the OPEC's concern that the structure is not competitive.

The OPEC plans to increase its capacity for advocacy at the same time as it is shifting enforcement attention toward cartel agreements and adding the capacity to perform new statutory responsibilities concerning state aids. Enforcement against cartel agreements will present novel and complex problems for an institution that has historically been involved more in administration than in investigation and prosecution. The new state aids responsibility and expanded attention to public procurement are valuable complements to the other competition policy enforcement functions, ensuring independent oversight of the troublesome problem of government-imposed distortions and restraints.

Thus the creation of a new regional layer of government presents both an opportunity and a set of new problems. The proposed change in statutory treatment of government-imposed distortions, by repealing Art. 18 and substituting a provision based on Art. 86 of the EU treaty, sends conflicting signals. It eliminates the clear prohibition against such distortions and introduces a more complex and less familiar rule. On the other hand, it connects Czech competition policy directly to a wide range of precedents and experience from other jurisdictions about the appropriate reach of the exemption and about what would be an essential, universal service.

6.3. Policy options for consideration

The following short to medium term options are presented for consideration to strengthen the scope, effectiveness and enforcement of competition policy, by eliminating gaps in coverage, enforcing competition law vigorously where conduct or conditions risk frustrating reform, and providing competition authorities with the authority and capacity to advocate reform and for competition policy and institutions to participate effectively in the transition to effective competition in deregulating, restructuring industries.

- *Consider formalising the relationships between the OPEC and new independent sectoral regulators.*

Before problems occur, it could be prudent to set out some ground rules about the respective jurisdictions, roles, and consultation responsibilities of these regulators and the OPEC. The OPEC may soon be in a position to take action over denial of access to networks that are under the regulators' jurisdiction (if it is not already in that position). Primary reliance on the competition law would be the best long-term approach, but co-ordination with the regulator could avoid surprises and inconsistencies.

- *Reconsider eliminating Art. 18, setting a competition policy standard for government action.*

Where regulators take actions that restrict or eliminate competition, Art. 18 empowers the OPEC to intervene, although the OPEC cannot order the other government body to change its conduct. The principle, prohibiting action by government authorities that restricts or eliminates economic competition, is valuable even if there is no mandatory sanction for violating it. Incorporating something like Art. 86 will help compensate for the elimination of Art. 18 in the draft of the new law, but the two provisions are not equivalent. Art. 18 is a clear, unambiguous prohibition, which applies to governments as such. By contrast, the language of Art. 86 applies to “undertakings” and thus the prohibition would apply only to government entities in their business capacity, not in their regulatory capacity. Moreover, it authorises exemption, if applying competition law would obstruct performance of their authorised services of “general economic interest” or “revenue-producing monopoly”. Another way to control government action distorting competition could be to authorise the OPEC to initiate constitutional court proceedings challenging other regulators’ actions. A proposal to that effect was eliminated from the draft law, though.

- *Apply substantive rules and investigative tools where they can help solve problems raised by industrial restructuring.*

Although the role of competition policy in most of the remaining restructuring tasks is secondary, there may be some issues where competition policy can play a role. Patterns of large investment holdings that are short of legal “control” could encourage company managements to avoid competition. This situation would pose an investigation problem. Such conditions may not come to enforcement attention, as they would not be covered by merger reporting obligations, even when those obligations apply to open-market acquisitions as well as formal merger agreements. Second, there could be a substantive problem. It may stretch the law too far to try to treat these potentially anti-competitive conditions as prohibited “concerted practices”. This is a difficult issue, which perhaps cannot be addressed except through vigilance in identifying non-competitive market conditions and applying the law strictly to observed infringements. The scope for these problems has already been reduced, by lowering the ceiling on investment fund holdings in a single firm.

A simpler task is ensuring timely competition policy review of restructuring projects. Although most such deals will not raise competition policy problems, some of them may, and those deals may be the high-profile ones. The understandable pressure for expedition in wrapping up transactions emerging from the Revitalisation Agency or bankruptcy proceedings could threaten the integrity of

competition review. The obvious solution is to consult at an early stage with the OPEC, perhaps even before bids are solicited.

- *Implement the planned leniency program to make cartel enforcement effective.*

The OPEC is studying how it could implement a leniency program, to assist in the investigation of secret hard-core cartels. This is a high-priority issue. Details of such a program will have to depend on details of the administrative and judicial processes, as well as on the credibility of the sanctions that parties could avoid by seeking leniency. Increasing attention to horizontal cartels may lead to unanticipated issues. Many cartels that are being unearthed in other jurisdictions have operated in international markets. It would be illuminating, and greatly complicating, if some of the major Czech firms that are now in the process of being reorganised are revealed to have been participating in such international cartels, or have been invited to do so.

6.4. Managing regulatory reform

The principal impediment to a healthier, competitive economy is the still-unresolved status of the inherited industrial structure. Managers of these enterprises need incentives to operate efficiently, disciplined by the demands of capital markets and the interests of equity holders, without recourse to direct or indirect public bail-outs and *ad hoc* fixes. Funds and elite attention are diverted to these high-profile entities. Concern to protect their interests probably slows needed general reforms to make market institutions work better. One such reform that is needed is a replacement of the bankruptcy law with one better designed for these large-scale reorganisations, rather than for winding up small firms and paying off creditors.

These problems are, in a sense, a consequence of what had been a virtue, the relatively well-developed high-technology industrial sector in the Czech Republic before 1990. Since then, the country has had the good fortune to have designed and established sound competition policy institutions and principles with a minimal number of exemptions and special regulatory regimes. That example, and the principles on which competition policy is based, could guide the restructuring process.

As the market economy puts down deeper roots, pressure will build to establish special regulatory protections against competition. The OPEC will have to resist that pressure through advocacy. Unlike the competition agencies in several neighbouring countries, the OPEC does not combine competition with other functions such as consumer protection and utility pricing. The combination can raise the agencies' public profile and demonstrate consumer benefits from enforcement oversight. The OPEC's somewhat narrower targets may have simplified its tasks and focused its efforts and resources. But concentration on

competition policy in the sense of restrictive business practices provides fewer opportunities to demonstrate the value of competition oversight to the public. To be sure, there is no sign that OPEC lacks support. Its budget and personnel resources are sufficient, even increasing, and it participates regularly in policy debate. But it is likely that it will have to take an even higher public profile on regulatory issues, to maintain the pro-competitive direction of reform.

Notes

1. Sec. 4, Austrian Coalition Act No. 43 of 1870.
2. Act No. 141/1933 Coll., on Cartels and Private Monopolies.
3. Amendment (No. 169/1969 Coll.) to Government decree No. 100/1966 Coll.
4. Act No. 63/1991 Coll., on the Protection of Economic Competition, as amended by Act No. 495/1992 Coll. and Act No. 286/1993 Coll.
5. References to the “OPEC” herein include the Ministry, with respect to the period 1992-96.
6. Articles 19 and 20 are not included in the draft of the new Competition Act, because they have become obsolete.
7. Creditors can petition the court to appoint a preliminary asset administrator to step in and ensure that the bankrupt firm’s management does not strip assets pending the completion of the process. Administrators will have less incentive to delay, too, under the new compensation scheme. Other changes may help overcome creditors’ reluctance to put debtor firms into bankruptcy involuntarily. Lower priority claims have a better chance of being paid at least in part. The settlement process can now propose issuing shares or securitising receivables, as well as paying creditors in cash.
8. The section below about these exemptions describes the situations of particular professions in more detail.
9. Act No. 199/1994 Coll., on Public Procurement, as amended by Act No. 148/1996 Coll. and Act No. 28/2000 Coll.
10. The general prohibition of unethical conduct that harms other firms might include some of the conduct that is considered abuse of economic dependence, such as refusing to comply with normal contract terms about payment
11. The appointment process and terms of office were changed by 1999 law, Act No. 187/1999 Coll., which amended the Act on the Operation of the Office, Act No. 273/1996.
12. The statute also permits dismissal of the chairman if he has not been in the office for more than 6 months. This provision may respond to a particular event, namely the previous chairman’s extended period of incapacity following a serious automobile accident.
13. www.compet.cz
14. Resolution No. 610, 16 September 1998.
15. Act No. 71/1967 Coll.
16. This power does not appear in the draft of the amended law. An equivalent power is granted to the OPEC and other agencies under Sec. 43 of the general Administrative Order (Act 71/1967 Coll., on administrative procedure).

17. This appeal process is set out in the general administrative code, Secs. 53 *et seq.*, Act No. 71/1967 Coll.
18. In the OPEC's latest annual report, nearly all of its leading priorities are policy-related. Some of these may be explicit responses to externally-applied demands or goals, such as the EU accession process):
 - performance of obligations under the Europe Agreement, such as harmonisation of the law and its application;
 - preparation for the assumption and performance of control over state aids;
 - improvement of legislative activities by more extensive co-operation with outside experts;
 - focusing on the most serious breaches of competition rules;
 - increasing transparency, both at the decision-making stage and with respect to information, interpretation, and methodology;
 - consistent defence of competition principles, in particular with respect to natural monopolies;
 - more extensive co-operation with partner competition offices in EU member States; and
 - reflection of topical issues in the application of competition law in legislative efforts.
19. Second-instance decision of the Office No. R 1/2000.
20. Judgement of the High Court No. 2A 9/97.
21. Judgement of the High Court No. 2A 6/97.
22. Judgement of the High Court No. 6A 78/95-24, 29 January 1999.
23. Judgement of the High Court No. 7A 134/95.

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PORTFOLIO EFFECTS IN CONGLOMERATE MERGERS

In the context of conglomerate merger review, portfolio effects seem to refer to the pro- and anti-competitive effects possibly arising when: the parties enjoy market power but not necessarily dominance; and the products joined are complementary or have analogous properties.

When complementary products are merged, there is a potential for considerable synergies that could benefit buyers. There is also an increased potential for forced tying, pure bundling, or analogous practices (*e.g.* full line forcing) that could restrict buyer choice but also lower prices. Under certain strict conditions, consumers could gain in the short run but suffer long term harm from such practices if they eventually result in a sufficient reduction of competitors and capacity in a market. The hypothetical nature of such harm has led some to conclude that instead of prohibiting mergers having potentially harmful portfolio effects, competition agencies should instead take a wait and see attitude. That would involve using abuse of dominance or monopolisation prohibitions to control negative effects should they actually materialise.

Executive Summary

By the Secretariat

Considering the discussion at the roundtable, the delegate submissions, and the background paper, a number of key points emerge:

1. *Portfolio effects in conglomerate mergers include potential pro- and anti-competitive effects that might arise due to a merger uniting complementary products in which one or more parties enjoy significant market power.*

The complementarities featured in conglomerate mergers displaying portfolio effects extend beyond classic economic complementarity. They cover as well “technical” complementarities (products which, for technical reasons, must be consumed together) and “commercial” complements (products forming part of a range which distributors need to carry, such as spirits, soft drinks, etc.). They also extend to products for which the strength of demand for one is positively correlated with strength of demand for the other (*e.g.* consumers with the strongest demands for spread sheets might also have the strongest demands for database managers).

2. *Mergers uniting complementary products in which at least one of the parties have considerable market power could facilitate forced tying, pure bundling or analogous strategies (e.g. full line forcing) that restrict buyer choice. While such conduct may initially increase economic welfare, it could, under certain conditions, ultimately have the opposite effect if it eliminates a sufficient number of competitors and capacity from the market.*

There are a number of possible welfare gains that forced tying and “pure” bundling (*i.e.* only the bundle, not its components, are offered for sale) could give rise to. They range from straightforward economies of scope (including the advantages of one-stop shopping for buyers), through savings related to quality control and customisation to improve complementarities, and on to more complex and uncertain welfare gains associated with efficient price discrimination and “Cournot effects” (discussed in the next section). On the other side of the ledger, it is possible that forced tying, pure bundling and closely analogous restrictive practices could,

especially in the long term, have some negative effects on welfare. The probability of an overall *reduction* in welfare is greater:

- the higher the degree of market power in the “tying” product (or one of the bundled products);
- the weaker the efficiencies, if any, associated with the impugned practices;
- the greater the increase in rivals’ costs induced by the post-merger tying/pure bundling strategy;
- the larger the number of buyers interested in purchasing only the tied product (or a subset of the bundled products);
- the more rivals find it unprofitable to match the tying/bundling strategy;
- the more certain are prices to rise above pre-merger levels due to foreclosure effects (*i.e.* the higher the probability that buyers will be unable to prevent such a price rise, firms will be unable to profitably enter or re-enter after prices have risen above pre-merger levels, and the tying firm will have an incentive to raise prices above pre-merger levels); and
- the more the expected long term price increases above pre-merger levels will be sufficiently large, quickly realised and durable that the tying/bundling firm will be able to re-coup any opportunity losses it might incur in reducing its rivals’ sales.

The short term, generally favourable effects of practices such as tying and bundling may be more easily and accurately predicted than long term negative effects that might arise through foreclosure. In balancing the two, competition authorities will generally wish to assign greater weight to more certain as opposed to more speculative outcomes.

3. *Mergers uniting complementary products could produce lower prices or other buyer advantages because of various economies of scope, transaction economies, “Cournot effects”, and strategic behaviour.*

Complementary products could share common inputs, promotional needs, or distribution channels and therefore be associated with important producer economies of scope when brought under common control. Analogous to this are transactions economies that buyers reap when purchasing complements from the same seller, *e.g.* savings in receiving one instead of several deliveries per week of spirits or soft drinks.

In addition to efficiency effects there is a less obvious reason why a merger uniting complements could lead to lower prices. Such a merger could also internalise the effects of lowering the price of one complement on sales and profits earned on another. This Cournot effect will not exist or be significant unless pre-merger prices were above competitive levels in at least one of the complements. Another necessary condition is that the

merged entity will either have a significant market share in at least one of the complements in which there were pre-merger supra-competitive pricing, or will engage in some form of tying, bundling or analogous practice having the effect of internalising a pricing externality in complementary products.

4. *Various transactional economies and lower post-merger prices, regardless of the cause, benefit buyers and normally count in favour of permitting a merger. There could be exceptions to that general rule in situations where it is strongly suspected that post-merger price reductions will end up causing such a large number of competitors to exit the market, that prices might eventually rise above pre-merger levels.*

Although theoretically possible, there will likely be few mergers in which competition authorities acting to protect consumer surplus will be forced to balance short term gains against long term losses to buyers. This is because the long term losses will not materialise unless all of a number of strict conditions are met, namely:

- the merged firm will enjoy such significant efficiencies and/or internalised complementary pricing as a result of the merger that it finds it profitable to drop prices (quality adjusted, *i.e.* accounting for non-price consumer benefits such as those associated with one-stop shopping) below pre-merger levels in at least one market whether or not it expects that price drop to induce competitors to exit (*i.e.* the price drop cannot be prohibited as predatory pricing);
 - neither rivals nor new entrants can match the merged firm's tying/bundling strategy (including through mergers of their own) and cost levels;
 - rivals will exit;
 - buyers cannot use countervailing power to hold prices at or below pre-merger levels;
 - firms will not enter or re-enter the market in response to price increases above pre-merger levels; and
 - the merged entity finds it profitable to raise prices above pre-merger levels (this might not be the case if its costs have declined sufficiently or too few rivals exit).
5. *In certain situations and jurisdictions it might make sense to apply an ex post rather than ex ante approach to suspected potential problems associated with conglomerate mergers involving portfolio effects.*

There may be mergers where the best response to suspected post-merger anti-competitive conduct is to rely on post-merger prohibitions and sanctions to deal with such conduct should it actually materialise.

There are two obvious advantages of employing an *ex post* instead of *ex ante* approach to mergers expected to produce behaviour having mixed pro- and anti-competitive effects, *e.g.* tying and bundling. First, in advance of

the merger, one can never be certain that such behaviour will in fact occur. Second, waiting until after it arises means that it can be assessed in actual market conditions which should greatly facilitate determining its likely net competitive effect. These advantages grow more significant the more certain are the short term benefits and the more long term and speculative are the possible anti-competitive effects.

The wisdom of adopting an *ex post* instead of an *ex ante* approach to potential problems associated with conglomerate mergers involving portfolio effects could well vary from one merger to another. This is largely because of differences in the certainty anti-trust authorities may have concerning the short and long term effects of such mergers, and in the ease and speed with which post-merger anti-competitive behaviour can probably be detected, assessed and remedied in various specific markets.

There could also be systematic differences across jurisdictions in the general superiority of an *ex post* versus *ex ante* approach to problematic mergers involving portfolio effects. In particular, jurisdictions which authorise rather than merely refrain from prohibiting mergers, might be less well placed to challenge post-merger anti-competitive behaviour. This could happen if courts find that the impugned behaviour was reasonably certain to occur at the time the merger was approved. That could be taken to imply that the competition authority did not consider it to have anti-competitive effects. This problem could be aggravated if a merger approval amounts to certifying that it does not create a dominant position, and dominance is a necessary condition for taking action against certain anti-competitive behaviour. In any case, jurisdictions could also differ significantly in the speed, certainty and deterrent power of public and private sanctions against anti-competitive post-merger conduct.

6. *Some of the differences across jurisdictions in how conglomerate mergers involving complements are analysed could be due to differences in the two tests being commonly applied, i.e. some jurisdictions employ a substantial lessening of competition test ("SLC test"), while others use a create or strengthen a dominant position test ("dominance test").*

A number of countries that specifically commented on the SLC and dominance tests in their written contributions or interventions at the roundtable expressed the view that the SLC test offers greater flexibility in dealing with portfolio or analogous effects. At the roundtable itself, one delegate expressed the view that the dominance test fosters greater reliance on market shares in establishing the harmful effects of a merger, while the SLC test enables measuring market power more directly. Another delegate noted that the SLC test might foster a fuller consideration of efficiency effects. On the other hand, one delegate expressed the

view that differences in tests were not likely as important as differences in economic approach, while another emphasised that market definition was a more critical issue.

Further to the market definition issue, discussion at the roundtable indicated that it might be fruitful to ask whether, in problematic mergers, the use of a dominance test pressures competition authorities to favour narrow market definitions in order to more easily establish dominance. It might also be asked whether in reducing market overlaps, overly narrow market definitions foster a need to develop portfolio effects concepts in order to discuss the anti-competitive effects of mergers uniting products which are weak substitutes. Otherwise put, is the dominance test tending to push jurisdictions to make greater use of the portfolio effects concept and to apply it beyond mergers joining strict complements?

7. *Given the uncertainty surrounding it, jurisdictions explicitly applying the portfolio effects concept in merger review should seek to offer guidance concerning the specific factors they will consider in assessing such effects. Such guidance could significantly improve transparency and predictability for both the business community and for other competition authorities examining the same merger.*

Some delegations endorsed the portfolio effects concept as improving the coverage and flexibility of merger review. One delegation, however, characterised this doctrine as introducing considerable uncertainty into merger review and creating the possibility that efficiency enhancing mergers might be rejected on the basis of speculative fears revolving around possible harm to competitors. Publishing guidelines describing how portfolio effects will be assessed in future mergers might help assuage such concerns. Such guidance might usefully consider similarities between the foreclosure effects associated with conglomerate mergers uniting complementary products, and analogous effects arising in some vertical mergers. Several delegations noted that in many of the cases in which authorities examined portfolio effects, what they were really looking at were standard horizontal and vertical effects. Furthermore, many such merger reviews ended up concluding that portfolio effects did not provide a sufficient basis for blocking the merger.

8. *Differences across jurisdictions in treatment of specific conglomerate mergers involving portfolio effects might be due more to differences in how facts are interpreted than to the application of divergent analytical approaches.*

In his summary remarks, the Chairman stressed what he found to be a fair amount of convergence in the analytical approach being cautiously applied to conglomerate mergers involving portfolio effects. He further remarked that all competition authorities emphasised the need to protect competition rather than competitors and were concerned to promote

efficiencies. The Chairman urged competition authorities to continue working on developing the empirical procedures applied to conglomerate mergers involving portfolio effects, including clarifying the questions investigated and the order in which the questions are considered.

The Chairman also endorsed one delegation's proposal that competition authorities should do more in the way of re-visiting their merger decisions to determine the extent to which the assumptions they made in the course of their reviews turned out to be vindicated by market developments. Such analyses could help correct any systematic biases in assessing the ability of competitors and buyers to respond to post-merger changes in competitive behaviour including greater use of tying and bundling, or enhanced incentives to predate.

Background Note

*By Gary Hewitt**

1. Introduction

Conglomerate mergers, unlike certain horizontal and vertical mergers, do not conventionally raise competition concerns. Nevertheless, in recent years, several conglomerate mergers, especially those featuring “portfolio effects”, have been opposed by some OECD competition authorities.

This paper investigates how “conglomerate mergers having portfolio effects” (defined below) could have important pro- and anti-competitive effects and based on that, contributes to developing sound policy towards such mergers.

In general terms, the paper finds that conglomerate mergers involving portfolio effects do not present new competition concerns. Rather they present traditional issues in new guises and combinations. To a considerable degree, the analysis applied in vertical mergers that are suspected of having exclusionary effects is found to be applicable to conglomerate mergers involving portfolio effects.

This paper's more specific key findings are:

A conglomerate merger uniting complements, and these probably account for a considerable proportion of conglomerate mergers involving portfolio effects, could facilitate tying, bundling, or closely analogous conduct. Such behaviour may increase overall welfare but it could also reduce it. Abstracting from merger specific efficiencies and analogous effects, the probability of a reduction is higher the more the following elements are present:

- a high degree of market power in the “tying” product (or one of the bundled products);
- rivals' costs are significantly increased;
- a large number of buyers interested in purchasing only the tied product (or a subset of the bundled products);

- rivals find it impossible or unprofitable to match the tying/bundling strategy;
- prices will eventually rise above pre-merger levels in the markets where rivals' costs are raised (*i.e.* buyers will be unable to prevent a price rise, firms will be unable to profitably enter or re-enter after prices have risen, and the tying firm will have an incentive to raise prices above pre-merger levels);
- price increases will be sufficiently large, quickly realised and durable that the tying/bundling firm will be able to re-coup any opportunity losses it might incur in reducing its rivals' sales; and
- buyers as a group will suffer a net loss despite any initial post-merger drop in prices.

As with other mergers, conglomerate mergers uniting complements could result in important efficiencies benefiting buyers. In addition, provided the parties have considerable market power and high market shares, such mergers could lead to price drops even absent merger related efficiencies. The reason is that under the hypothesised circumstances, uniting complements under common ownership gives the new entity an incentive to lower the price of one (or all) complements in order to realise larger sales and profits on the other complementary product(s) it sells. Such efficiencies and internalised complementary pricing factors could mitigate against the merged entity raising prices above pre-merger levels.

Merger specific efficiencies and the effects of joint pricing of complements (or analogous effects) would normally increase economic welfare, including benefits to buyers if prices drop post-merger. However, if prices do drop initially, it is also possible that they will later rise above post-merger levels. For reasons analogous to predatory pricing, it is possible that buyers will suffer net harm as a result. For that possibility to materialise, seven conditions must all be satisfied:

- the merged firm will enjoy such significant efficiencies and/or internalised complementary pricing (or analogous) effects from the merger that it finds it profitable to drop prices below pre-merger levels in at least one market whether or not it expects that price drop to induce competitors to exit (*i.e.* the price drop cannot be prohibited as predatory pricing);
- neither rivals nor new entrants can match the merged firm's new costs;
- rivals will exit;
- buyers cannot use countervailing power to hold prices at or below pre-merger levels;
- firms will not enter or re-enter the market in response to price increases above pre-merger levels;

- the merged entity finds it profitable to raise prices above pre-merger levels; and
- what buyers initially gain through prices set below pre-merger levels is less than what they later lose through paying higher than pre-merger prices.

A conglomerate merger not joining complements could also facilitate tying and bundling but the profitability, hence the probability of these practices emerging post-merger might be low unless there is a high correlation across consumers in the values they place on the products being united. In addition, in the case of bundling, low marginal costs could also be critical. These conditions could be satisfied in the case of certain information products such as computer software.¹ The welfare effects of such tying and bundling are broadly similar to the case involving complements.

Tying and bundling could be used as a type of price discrimination that could, but not necessarily would, reduce economic welfare, even if does not result in anti-competitive exclusion/restriction of competitors.

To the degree a conglomerate merger raises concerns about anti-competitive tying and bundling, these may be better resolved through an *ex post* rather than an *ex ante* approach, *i.e.* using abuse of dominance provisions to control anti-competitive behaviour, if it occurs, rather than merger provisions.

It is not possible to develop a simple checklist that would allow competition authorities to distinguish harmful from benign conglomerate mergers having portfolio effects. There are, however, some characteristics that would help in making preliminary decisions concerning the probability that such a merger would reduce economic welfare. That probability is likely to be significant if:

- the parties enjoy considerable market power in the products being united;
- the united products are “complements”;²
- the marginal costs of producing united “complementary” products are low; and
- remaining competitors and new entrants are unlikely to be able to match any efficiencies and bundling advantages that the merging firm might reap.

Although the commonly accepted distinction between a vertical and conglomerate merger depends on whether or not there was a pre-merger customer-supplier relationship, the probability that tying or bundling facilitated by a merger will prove anti-competitive does not significantly depend on that distinction.

The remainder of this paper is presented in seven parts. We will begin with some definitions and then present some excerpts from three merger decisions chosen to highlight the kinds of competition concerns arising in conglomerate mergers involving what this paper will refer to as portfolio effects. In section four of the paper we will take a close look at tying and bundling, the two practices at

the heart of concerns about conglomerate mergers involving portfolio effects. Following that, we will examine as well the possibility that such efficiencies could end up harming rather than benefiting buyers. The paper ends by considering whether an *ex ante* or *ex post* approach is best suited to addressing the competition concerns that may arise in some conglomerate mergers involving portfolio effects, and by providing some policy conclusions. As much as feasible, supplementary description and technical matters are confined to the paper's two appendixes.

2. Definitions

In this section, we examine a standard definition of conglomerate mergers and argue that it may be unhelpful if it unduly constrains the analysis of a conglomerate merger involving complementary products. We then offer a definition of "portfolio effects" and describe some conglomerate mergers where such effects were apparently important.

2.1. *The Definition of a Conglomerate Merger and the Need to Avoid giving it Undue Influence over Merger Review*

For the purposes of this paper, a conglomerate merger is defined as one in which the parties to the merger "... are not actual or potential competitors and the parties do not have an actual or potential customer-supplier relationship".³ This definition begs the question of exactly what constitutes a "potential" competitor or a "potential" customer-supplier relationship. The answer would probably vary from one jurisdiction to another, but the basic idea in the case of competitors would be that neither firm was exerting any competitive discipline on the other prior to the merger. As regards a potential customer-supplier relationship, we assume this refers to a situation where a party to a merger is presently competing with another party's current supplier or client. That assumption is intended to deal with the following definitional issue. If a merger unites two products, that are not substitutes, and the parties clearly intend to bundle those products post-merger, were the parties in a potential buyer-supplier relationship at the time of the merger? Under our definition, they were not and the merger would consequently be classified as conglomerate. This points to the issue of whether the dividing line between vertical and conglomerate mergers is potentially unhelpful.

In terms of assisting in grouping and analysing pro- and anti-competitive effects, it makes sense to treat a merger of two firms actually or potentially producing substitute products as a horizontal merger. The same applies to mergers joining firms in actual or potential customer-supplier relationships, *i.e.* vertical mergers, although those would, arguably, be more helpfully defined as mergers of complements. The problem is that the remaining category is unhelpfully diverse. It fails to distinguish between conglomerate mergers uniting complements and those which do not.

Two products are complementary, in the traditional sense of that word, if they are more valuable to the buyer when consumed together.⁴ This applies to a large range of products. Many products are not useful on their own but only when combined in some way. Left and right shoes are one example. Computer software and hardware are another. Even amongst computer hardware there are clear complementarities. A computer hard disk is useless without a working central processor. A central processor is useless without a working computer screen and so on. The same applies in the aircraft industry – aircraft engines are useless without airframes to mount them in. Aircraft avionics are useless unless the aircraft has engines to power it, etc.

In assessing the probability that a conglomerate merger will lead to welfare reducing price discrimination or welfare reducing exclusion/restriction of competitors, is the presence or absence of a pre-merger customer-supplier relationship always decisive? From the ultimate consumers' point of view, the answer is no. This point can be illustrated with a simple hypothetical example. Suppose Firm A held the patent and was the only firm selling brake lights that customers installed in the back windows of their cars. Suppose further that before any of its competitors did so, car manufacturer believed it could install such lights while a car was being assembled at lower costs than consumers could after they purchased a new car. If it initially decided to purchase brake lights, but later merged with that firm, the merger would be treated as a vertical merger. If instead it had never purchased the lights, the merger would be a conglomerate merger. Despite the classification difference, the pro- and anti-competitive effects of the two mergers would be the same. More particularly, the firm's post-merger decision to refuse to offer the brake lights separately, or to offer them only at an increased price would have the same effects on economic welfare, whether or not the merging parties had a buyer-seller relationship.

We have been focusing on conglomerate mergers involving complements, but the points being made generalise to all conglomerate mergers involving portfolio effects (as defined below). From the ultimate consumer's point of view, the important issues are whether or not the merger will:

- result in some form of welfare reducing price discrimination; and/or
- tend to eliminate suppliers offering substitutes for one or both of the merged products.⁵

The probability of either of these results materialising depends a great deal on the production and demand side inter-relationships between the products being combined in a conglomerate merger.

2.2. Definition of Portfolio Effects

“Portfolio effects” is a somewhat vague term for which we could find no generally accepted definition. From a reading of a number of cases using the term, we deduce that portfolio effects in the context of conglomerate mergers usually refer to the pro- and anti-competitive effects that may arise in mergers combining branded products:

- in which the parties enjoy market power, but not necessarily dominance; and
- which are sold in neighbouring or related markets.⁶

The concept of “neighbouring or related markets” is intended to describe a demand side linkage between markets, *i.e.* a significant degree of commonality in terms of buyers served. The clearest but not the only example of such a linkage would be complementary products.

In this paper, we will adopt the above deduction as a definition of portfolio effects, except that we will drop the reference to “branded”. Our definition therefore extends to some conglomerate mergers joining intermediate products.⁷ The reason for making this extension is that the potential pro- and anti-competitive effects we wish to concentrate on do not heavily depend on the presence or absence of strong brands.

3. Anti-competitive Effects Allegedly Arising in Conglomerate Mergers Involving Portfolio Effects

The principal antitrust concerns with regard to conglomerate mergers having portfolio effects seem to be that such mergers may indirectly solidify or magnify market power by facilitating various behaviours rather than directly by altering market structures. To illustrate what these behaviours consist of, and to demonstrate how they may inter-relate, we present some excerpts from a European Commission merger decision and from a description of a Swiss merger decision. We will also supply an excerpt from the European Commission's press release concerning its *General Electric/Honeywell* merger decision. Excerpts from two more European Commission conglomerate merger decisions can be found in Appendix A to this paper.

Before presenting the excerpts, we need to make three points. First, the excerpts are not intended to reflect all the competition issues arising in the cited cases. Second, the excerpts do not contain much if any of the evidence mustered to bolster the allegations/findings. Finally, the focus on the European Commission and Switzerland is not intended to imply that these are the only jurisdictions where portfolio effects in conglomerate mergers have been considered. We expect that the country submissions for the roundtable discussion on this topic will provide further examples that we are not yet aware of.

3.1. Guinness/Grand Metropolitan

In this merger, the European Commission determined that there were a number of different product markets. In the Greek market, those product classes were: whisky, gin, rum, brandy, the various liqueurs and the local ouzo aperitif.

The merging parties divested the distribution of Bacardi rum in Greece in order to address the Commission's tying concerns which were apparently rooted in the merger uniting a number of strong brands extending across all the major product categories typically offered in bars and other by the drink outlets. The Commission believed that Diageo (*i.e.* the new entity created by the merger) would have had the power to engage in full-line forcing having the effect of building up its weaker brands as well as further strengthening the position of its "must have" brands. This alleged tying power was described in terms that mixed it with more general concerns about other advantages Diageo would enjoy over competitors. Focusing on portfolio effects in the Greek market, the Commission decision stated:

... a deep portfolio of whiskey brands, spread out across the various quality and price segments, confers considerable price flexibility and marketing opportunities. Therefore, the supplier is shielded from market pressures, as he is able to face price competition from other suppliers' brands by positioning and pricing his various brands within the category. For instance, with its secure high market performance of the best-selling whisky brands, GMG will be able to devote as many resources as necessary in order to maintain its secondary brands in their position or to reposition the weaker brands upwards by expanding their share at the expense of competing brands, or in order to counter eventual competitive pressure coming from those brands. The parties have argued that such "pull-through" has not occurred in the past and is accordingly unlikely to occur in the future. However, this argument ignores the substantial increase in the parties' market shares and resources that the merger will create.

Moreover, a wide portfolio of categories confers major marketing advantages, giving GMG the possibility of bundling sales or increasing the sales volume of one category by tying it to the sale of another category. Both Guinness and GrandMet have made use of their portfolios of brands in bundling deals... For instance, in 1995, GrandMet rewarded customers who collected and delivered (confidentiality deletion) bottle-caps of Smirnoff, Cuervo and J&B, by offering them a free [...]. For the same number of caps, wholesalers received a credit note of [...]. Moreover, Guinness made joint promotions of different categories and brands, whereby customers purchasing a 12-bottle pack containing Johnnie Walker Red Label (seven bottles), Gordon's gin (two bottles) and White Horse (three bottles) obtained a discount of [...]. It should be noted that these promotional campaigns were run with the co-operation of wholesalers who supplied the various trade channels. Finally, in 1996 GrandMet carried a similar discount campaign for

wholesalers, offering discounts for purchases of [...] cases of a pre-selected mixture of the following GrandMet brands: J&B ([...]), Smirnoff ([...]), Cuervo ([...]), Bailey's ([...]), Grand Marnier ([...]) and Malibu ([...]).

In the on-trade (by the drink, *e.g.* bars and restaurants), where spirits producers build a brand's strength and image, GMG, through its broad portfolio of brands, would be able to influence what products are stocked or displayed in the limited space available behind the bar, (the so-called back-bar), thus further strengthening its market power. For small outlets which have smaller back-bars, or for Greek night-clubs which concentrate on whiskey, the combined entity would be an attractive solution for one-stop-shopping considerations. In addition, larger modern outlets, which usually stock a much broader variety of brands, may also become a target of the combined entity, should it attempt to gain more back-bar space or use the image of fashionable clubs in order to launch its brands. GMG could afford to make substantial offers, discounts and credits or organise and finance promotional events, that would also accrue to the outlet itself, and use its strength in leading brands, such as Johnnie Walker Red Label, Gordon's gin and Bacardi rum, in order to induce bars to list brands in the same or another category. Given that those premises could not afford not to stock the brands set out above, the negotiating power of GMG would be significantly strengthened. Therefore, it would be much easier for GMG to induce bar-tenders to adopt GMG brands as pouring brands (that is, the brand offered when a customer fails to specify a brand by name), thus increasing their sales volumes and public awareness.

In the off-trade, the elimination of competition between Guinness and GrandMet for in-store promotions will serve to enable GMG to plan jointly the timing of promotions, negotiate jointly the terms of promotions and co-ordinate any price changes. Moreover, through its variety of brands, GMG could also alternate branded products promoted over a period of time, thus occupying long promotion periods and excluding competitors from access to the promotion calendar for long periods.

By comparison, competitors have weaker portfolios and fewer strong brands, as stated in the preceding paragraphs, although those brands may have performed well, they lack the support of a strong portfolio of brands. Indeed, in contrast to the complete GMG portfolio, the discontinuity of the competitors' portfolios would deprive them of price flexibility and make them more vulnerable to market pressures. For example, when their brands start losing sales volume, they will have to commit disproportionately stronger resources in order to avoid situations that could in the long run restrict their competitive scope.⁸

Some of the same types of portfolio effects can be found as well in the European Commission's decision regarding the *Coca Cola/Carlsberg* joint venture decision.⁹

3.2. Unilever/Best Foods

The following is an excerpt from the Swiss contribution to the OECD's Competition Law and Policy Committee roundtable on portfolio effects in conglomerate mergers. The Swiss Competition Commission's preliminary investigation in this case led to the conclusion that the merger was not illegal. During the preliminary investigation, no important product overlaps were found but there was concern about possible portfolio power effects because, "... the merger resulted in the union of a considerable number of products and brands within one single company...".¹⁰ The submission continued with:

The following potential problems with portfolio power have been considered:

- increased pricing flexibility, including the possibility to offer promotions and discounts with a potential for abuse;
- increased scope for bundling (tying the provision of one product with others);
- increased credibility of implicit or explicit threats of a refusal to deal.

In the analysis of portfolio effects, the presence of a "key brand" in at least one product market has been presumed to be a necessary condition for a potential abuse of portfolio power.

A key brand is a highly successful brand for which consumers find it difficult to find a substitute.

Therefore, it had to be assessed whether UL or BF produced key brands.

Because retail customers seem to attach more importance to brands than business customers (hotels, restaurants) or institutional customers (hospitals, homes for the aged), the analysis focused on the retail sector.

According to the retailers interviewed, UL and BF both produced products, which were leaders in their sector. Nevertheless, it is difficult to assess whether these brands constituted key brands according to the definition provided above. According to the retailers, consumer preferences change rapidly in the food sector. Regularly, brands lose their position as number one and are replaced by other brands. In other words, according to the retailers, a well established brand today is no guarantee for success tomorrow in food markets.

Similarly, retailers doubted that bundling, by which retailers would be forced to purchase certain goods if they would like to be provided with leading brands, would raise important problems for them. The level of concentration in the retail sector and the resulting buying power of retailers (of Coop, in particular) seems to play a crucial role for the present merger, insofar as it has a disciplinary effect on producers.

In summary, the buying power of trading partners, which are highly concentrated, was considered to be sufficient to avoid abuse of portfolio power by UL and BF. In addition, the leading brands' life cycles seem to be limited as a result

of rapidly changing consumer preferences. Moreover, strong actual and potential competition between producers reduces the scope for abuse of portfolio power. For instance, firms like Nestlé and Migros are strong actual and potential competitors.¹¹ Because of their global know-how in the foods sector and their financial resources, these firms are able to rapidly enter new product markets if they expect substantial benefits.¹²

3.3. General Electric/Honeywell

This is one of the European Commission's most recent decisions in a conglomerate merger involving what this paper classifies as portfolio effects.¹³ The decision has not yet been published, so we can only present excerpts from the press release announcing the decision.

GE and Honeywell notified their merger agreement for regulatory clearance in Europe on 5 February this year. On March 1, the Commission started an in-depth investigation which demonstrated that GE alone already had a dominant position in the markets for jet engines for large commercial and large regional aircraft. Its strong market position combined with its financial strength and vertical integration into aircraft leasing were among the factors that led to the finding of GE's dominance in these markets. The investigation also showed that Honeywell is the leading supplier of avionics and non-avionics products, as well as of engines for corporate jets and of engine starters (*i.e.*, a key input in the manufacturing of engines).

The combination of the two companies' activities would have resulted in the creation of dominant positions in the markets for the supply of avionics, non-avionics and corporate jet engines, as well as to the strengthening of GE's existing dominant positions in jet engines for large commercial and large regional jets. The dominance would have been created or strengthened as a result of horizontal overlaps in some markets as well as through the extension of GE's financial power and vertical integration to Honeywell activities and of the combination of their respective complementary products. Such integration would enable the merged entity to leverage the respective market power of the two companies into the products of one another. This would have the effect of foreclosing competitors, thereby eliminating competition in these markets, ultimately affecting adversely product quality, service and consumers' prices.¹⁴

Considering the preceding material (plus two case excerpts in Appendix A), the principal antitrust concern with regard to conglomerate mergers having portfolio effects seems to be that such mergers may facilitate anti-competitive tying, bundling or closely related behaviour. In the process of examining this concern we will also touch on how tying and bundling could effectively amount to price discrimination.

4. Tying and bundling

4.1. Preliminary remarks

In this paper tying will be taken to be the practice of “... requiring any person or class of persons to whom goods or services of any description are supplied to acquire other goods or services as a condition of that supply”.¹⁵ Ties are often implemented through contractual obligation, but they may also be arranged through the use of various discounts and rebates, or customisation tending to force a buyer to buy complementary products from the same supplier.¹⁶

“Tying” and “bundling” are sometimes used synonymously, but in this paper bundling will refer to situations where the seller determines the proportions in which two products are purchased. For examples, shoe manufacturers “bundle” rather than “tie” shoes with shoe laces, and automobiles are bundled with many components such as shock absorbers, exhaust systems, headlights etc.

Since tying and its variants tend to restrict consumer choice and with it competition, antitrust laws have generally been wary of the practice. In the United States, tying can be treated as *per se* illegal if four elements are satisfied:

- the tying and tied goods are two separate products;
- the defendant has market power in the tying product market;
- the defendant affords consumers no choice but to purchase the tied product from it; and
- the tying arrangement forecloses a substantial volume of commerce.¹⁷

In practice it is far from easy to prove all the required elements. In addition, both in the United States and generally in other jurisdictions, competition authorities increasingly recognise that tying can have a wide range of pro-competitive effects ranging from reduced production costs to ensuring appropriate quality. It could also, more controversially, improve economic welfare by permitting various forms of price discrimination. We return to this point below.

In theory, there is no need for a tying seller or a firm wishing to bundle products to own production facilities for the tied or all bundled products. In practice, however, there could be good reasons why a conglomerate merger uniting potential tying/tied or bundled products could increase incentives to engage in the practice. A merger will considerably reduce the costs and risks associated with negotiating with another firm the division of the expected gains from tying or bundling. Those costs and risks are considerably compounded in situations where both parties have some market power, and that is presumed to be the case in conglomerate mergers involving portfolio effects. Moreover, the risks are further increased if customisation involving high sunk costs is required in order to maximise the return from tying or bundling.¹⁸ That too may be

characteristic of conglomerate mergers involving portfolio effects because many of them involve uniting complementary products which might benefit from such customisation.

4.2. Analysis of tying/bundling – price discrimination aspects

Tying or bundling might be employed as a means of price discrimination in circumstances where a more straightforward approach to doing the same thing is illegal or infeasible. For example, it might be attractive to firms with market power that cannot distinguish high from low demand customers.¹⁹

Tying as price discrimination is often illustrated with IBM's early policy of tying leased mainframe computers, in which it had considerable market power, and punch cards used to feed instructions and data into the machines. The punch card market was considerably more competitive, or at least potentially so, than the market for leased computers. In imposing the tie and charging a supra-competitive price for the punch cards, IBM had found a way of effectively charging high use lessees more than low use lessees. This almost certainly increased IBM's profits. It may also have improved economic welfare if the result was:

- more efficient (*i.e.* cheaper) customisation at the interface between tying and tied products (somewhat unlikely in the IBM case);
- lower costs of quality control (*i.e.* avoiding the problem of consumers failing to appreciate the full effects of using cheaper but poorer quality complements);
- increased “output” in the tied product; and/or
- a more efficient spreading of the fixed costs of innovation across consumers (*i.e.* a better approximation to Ramsey pricing).

In the IBM case and other examples of “metering”, the tying and tied goods are necessarily complements. In addition, tying can profitably and perhaps efficiently be used to price discriminate even when the tying and tied products are not complements as traditionally defined. Instead they may simply be related in the sense that if something is known about the strength of a buyer's desire for one good, this will reveal something about the buyer's strength of desire for the other good. This is sometimes referred to as “stochastic dependence” in demand. In particular, such dependence exists when there is a positive correlation across buyers in the strength of their demands for the tying and tied products.

Mathewson and Winter (1997) gave several examples of how tying could be explained by stochastic dependence. One of these involved the terms on which some US oil refineries used to sell gasoline to their franchisees. In addition to exclusive dealing, the petrol station operators were required to purchase tires, batteries and other automobile accessories from designated producers who in

turn paid a ten per cent commission on such sales to the tying oil companies. Although these are complements from the point of view of final buyers, that may not have been the reason oil refineries imposed tying on their gas station lessees. Mathewson and Winter observed:

It is reasonable to impute a positive correlation to the sale of gasoline and other automobile accessories at retail sites. For example, residential sites that have heavy traffic are likely sites where gasoline and tire sales are both high. Yet (it) is unlikely that tying the sale of accessories to gasoline is driven by price dependence in demand. That is, there is no reason to imagine that the sale of gasoline or tires at one site is conditioned on the price of the other good. Nor does the metering argument for tied sales appear to be applicable. Rather, it is reasonable to suggest that these tie-in arrangements were a contractual device to extract additional surplus from station owners because of the price-setting powers accruing to the oil companies through brand name and locational attributes (571, reference omitted).

Mathewson and Winter also observed that the existence of stochastic dependence could explain why tied selling and two part pricing (a form of “second degree” price discrimination) could be found together:

Without tying, a monopolist using two-part pricing must collect rents through a fixed fee and only one variable price. Tying is profitable when the stochastic demands for two products are positively related across buyers, because it offers the monopolist an opportunity to extract increased rents from intensive users through a more efficient combination of variable prices. Tying leads to greater reliance on variable prices to collect rents, and the corresponding drop in the fixed fee is enough that a larger set of consumers purchases under tying. Tying is therefore never Pareto inferior, and it may be Pareto improving in our model (576).

Stochastic dependence in demand could also explain why bundling may be used, in effect, to price discriminate, but in this case it is a *negative* rather than a positive correlation across buyers in terms of the strength of demand for both goods that is responsible for the profit enhancement. Stigler (1963) illustrated this point in relation to the practice of block booking of films leased to cinemas and Varian (1989, 626-627), using slightly different numbers, described it as follows:

- Suppose that there are two theaters, A and B. A is willing to pay \$9 000 for film 1, \$3 000 for film 2, and \$12 000 for the package. B is willing to pay \$10 000 for film 1, \$2 000 for film 2, and \$12 000 for the package. Notice that the value of the bundle to each theater is simply the sum of the values of the two films; there are no “interaction effects” in the consumption of the two goods.
- Suppose that costs are zero, so that the movie rental company is only interested in maximising revenue. If the rental company rents each film individually, profit maximisation requires that it rent film 1 for \$9 000 and

film 2 for \$2 000 making a total of \$11 000 from each theatre. But if it rents only the bundled package it makes \$12 000 from each theatre. Effectively the rental company has managed to price discriminate between the two theatres; it is renting film 1 to theatre A for \$9 000 and to firm B for \$10 000 and similarly for film 2.

This example illustrates an important point: bundling is most effective when there is a negative correlation between the consumers' valuations of the goods. In the case illustrated, theatre A's value for film 1 is less than theatre B's, but theatre A's value for film 2 is higher than theatre B's.

It is worth noting that although there is a negative correlation in buyer valuations of the goods in the example just described, the goods might still be traditional complements.

The film rental example illustrates what is usually referred to as pure bundling because only a seller determined bundle of films is being offered. In most markets it is more common to find mixed as opposed to pure bundling. With mixed bundling, the components are also sold separately. To make sense, however, the price of the bundle must be *less* than the total price of the components purchased separately. Restaurants offering fixed menus and offering the same dishes "à la carte" are practising mixed bundling. Even more than with pure bundling, the mixed variety allows a seller to charge, in effect, different groups of self-selecting buyers different prices for the same goods.

The welfare aspects of pure and mixed bundling were systematically explored in a seminal article by Adams and Yellen (1976). Their major contribution was to show that price discrimination through bundling can be profitable even without a negative correlation in buyer "reservation prices" for bundled goods, and also without expressly assuming that the goods are complements.²⁰ A description of their model and its implications can be found in Appendix B of this paper. It should be highlighted that their model assumed that the seller of the bundled products enjoyed a monopoly in both.

Adams and Yellen noted that bundling could produce a wide variety of effects on total economic welfare (*i.e.* the sum of consumers' and producers' surplus) depending on the levels of marginal costs and the distribution of reservation prices across consumers.²¹ The level of marginal costs is important because even with mixed bundling there could be a loss in social welfare to the extent that some bundle buyers place a very high value on one of the bundled goods but value the other at less than its marginal costs of production.²²

Although even mixed bundling could result in less social welfare than pure competition, Adams and Yellen make a very valuable point when they note that pure competition may not be the relevant benchmark. This is particularly pertinent to merger review where the comparison is necessarily between pre- and

post-merger conditions. Prohibiting a merger in order to block bundling of products in which there is a high degree of pre-merger market power might make society worse off. As Adams and Yellen point out:

... within the framework of our model, whenever mixed bundling is equivalent to pure price discrimination, it is Pareto optimal. Simple monopoly pricing never is (495).

In the context of a reviewing a conglomerate merger involving portfolio effects, attention is necessarily devoted to whether the merger makes consumers worse off. Even if it were certain that such a merger would lead to a form of price discrimination through bundling and price discrimination would not be possible without the merger, that would not necessarily mean that the merger will harm buyers. This is another manifestation of the point that it is difficult to generalise about the effects of price discrimination.²³

As already noted, the benchmark employed by Adams and Yellen was a situation where a single producer had monopoly power in the two bundled goods rather than one in which ownership of the two was initially separated. As such they did not have to mention an important point described by Nalebuff (2000, 1-2) and ascribed to Cournot. To the extent two products are complements, bringing them under common ownership will internalise the effect of a drop in the price of either on the sales of the other, *i.e.* without the merger, the firm that cuts the price would not reap the full benefits of the cut.²⁴ This should result in a lower price for both goods. This effect must be remembered when considering the welfare effects of an increased probability of tying or bundling occasioned by a conglomerate merger involving portfolio effects.

Appendix B describes some interesting extensions to the Adams and Yellen model presented in Schmalensee (1982) and Schmalensee (1984).

4.2.1. *Summing up concerning the price discrimination related aspects of tying/bundling*

Insofar as a conglomerate merger involving portfolio effects facilitates tying and bundling it could affect how existing market power is exercised. Both tying and bundling could make it possible to transfer more surplus from consumers to producers through an indirect kind of price discrimination in situations where more straightforward price discrimination might otherwise be infeasible. Tying is most profitably employed where there is a positive correlation across consumers in the value they place on the tying and tied products. Bundling might instead be favoured in cases where that correlation is negative *and* marginal costs of producing the bundled products are low.

It is difficult to analyse the total welfare effects of tying and bundling in cases where there is no change in market power. Tying involving complementary products and employed as a metering device facilitating price discrimination

could result in a larger output, hence tend to increase total welfare beyond what it would be without the practice (*i.e.* assuming nothing can be done to reduce market power in the tying product). It could also have positive effects in terms of fostering production efficiencies or in ensuring improved complementarity among goods. Bundling, especially pure bundling, may be less likely than tying to increase total welfare because it could result in sales to individuals who value one of the bundled goods at less than its marginal costs of production. In general, all one can say is that the total welfare effects of bundling used to effect price discrimination depends on the marginal costs of producing the bundled products and the nature of any correlation across consumers in the values they place on those products.

Whether or not it facilitates tying/bundling, something more might need to be said concerning the total welfare effects of a conglomerate merger involving portfolio effects. To the extent the merging parties enjoyed large market shares and market power in complementary goods, there will be a tendency for prices to decline post-merger because the effects of price drops in one complement on profits in the other will be internalised instead of being ignored.

In short, fears that a conglomerate merger involving portfolio effects would lead to a welfare reducing type of price discrimination involving tying or bundling could be a thin reed to lean on as the *sole* rationale for blocking the merger. This is especially so if it can be shown that the elements necessary for price discrimination were already present pre-merger.

4.3. Analysis of tying and bundling – market power aspects

In this section we will examine some of the ways in which tying and bundling can solidify or increase market power.

4.3.1. Tying as a means of excluding or restricting competitors in the tied product market

As a general rule a monopoly producer of good A cannot increase its profits by tying the sale of A to product B (tied product); a monopoly profit can only be taken once. However, Whinston (1990) demonstrated an important exception to this general proposition. If there are significant economies of scale in the tied product, then tying raises unit costs for tied product competitors. That in turn would tend to foreclose the market for the tied product competitors or at least reduce their ability to constrain price rises in their market. The result would presumably be higher prices in the tied product market and increased total profits for the tying firm, especially if there are buyers interested in buying only the tied good.²⁵

To have the effects Whinston envisaged, the tying firm must find a credible means of pre-committing itself to tie. With such a credible commitment, the tying firm becomes a more aggressive competitor in the tied product. In other words, potential entrants into the tied product would not expect the tying firm to accommodate their entry. Rather it would vigorously defend its sales of the tied product

since if it loses sales there, it also loses sales of the tying product. Whinston thought a credible pre-commitment to tie would be achievable in a wide range of circumstances.²⁶

Whinston's models include the assumption that because of significant economies of scale the tied product market is initially a duopoly. Most of the models also have two more things in common. First, in all but one case, the tying and tied products are not purchased in fixed proportions.²⁷ Second, and considerably more important, Whinston assumed an unassailable monopoly in the tying product. In that context, there is no need to explain why a disadvantaged tied good producer does not defend itself by entering the tying goods market. Such a counter strategy has been addressed, however, in closely related articles dealing with foreclosure through vertical integration. Two of those are presented in Appendix B. It is also addressed in the next sub-section of this paper where we discuss ideas presented in Nalebuff (2000).

The European Commission review of the merger between Boeing and the Hughes Space and Communications Company ("Boeing/HSC") illustrates how close analysis will sometimes reveal that the power to tie is more apparent than real.²⁸ The European Commission found some overlap between the parties' satellite product lines but was also concerned about the potential interaction between satellites and launch services. It was feared that the merged entity would be able to use various tactics to tie satellite sales to the use of Boeing launch services.²⁹ After canvassing consumers, the European Commission concluded that it would not be profitable for the merged entity to institute such a tie, because buyers put a high premium on being able to employ a number of launchers rather than risk depending on just one.³⁰

There may not be many conglomerate mergers involving portfolio effects which present serious risks of market power leveraging from a tying to a tied product. The seriousness of such risks depends on a number of elements. Before listing those, we note that despite our focus on tying, the analysis in this sub-section of the paper applies as well to mixed bundling (*i.e.* a situation where components as well as a discounted bundle are offered for sale). The elements tending to increase the risk that tying/bundling will reduce welfare through market power leveraging are:

- a high degree of market power in the "tying" product (or one of the bundled products);
- rivals' costs are significantly increased;
- a large number of buyers interested in purchasing only the tied product (or a subset of the bundled products);
- rivals find it impossible or unprofitable to match the tying/bundling strategy;

- prices will eventually rise above pre-merger levels in the markets where rivals' costs are raised (*i.e.* buyers will be unable to prevent a price rise, firms will be unable to profitably enter or re-enter after prices have risen, and the tying firm will have an incentive to raise prices above pre-merger levels);
- price increases will be sufficiently large, quickly realised and durable that the tying/bundling firm will be able to re-coup any opportunity losses it might incur in reducing its rivals' sales;³¹ and
- buyers as a group will suffer a net loss despite any initial post-merger drop in prices.³²

Concerning the fifth element, there are several reasons why the tying/bundling firm might wish to lower prices following a merger, at least initially. To begin with, tying/bundling could induce various efficiencies in both production and distribution. In addition there is the earlier mentioned effect of internalising the impact of a price drop in one of a number of complementary products. That effect would be reinforced in the case of a firm committing itself to tying/bundling. In fact, such a commitment would create its own price lowering tendency regardless of whether the products are complements or not.³³ The welfare impact of an initial post-merger price cut, whatever its cause, is hard to assess because it might contribute to an exit of competitors and a long run increase in prices above pre-merger levels. We return to that issue in Section VI.

4.3.2. *Tying or bundling intended to consolidate market power*

In the previous section we concentrated on how tying could be used to increase market power in a tied product, *i.e.* leveraging. Here the focus shifts to examine how tying or bundling facilitated by a conglomerate merger could consolidate market power.

Consider first the case of a company, "Firm 1", which is initially alone in the market for A but faces a more efficient competitor, *i.e.* Firm 2, in the market for complementary product B. One would normally expect Firm 1 to be content to allow Firm 2 to expand because that would help Firm 1 earn more profits in A. The game changes considerably though if Firm 1 faces the possibility of competition in A and there are significant economies of scale or network economies in B. In that case, Firm 1 might prefer to engage in practices having the effect of keeping Firm 2 small and inefficient. That would assist Firm 1 by denying a potential entrant in A the benefit it could derive through its customers having access to a high quality B complement. Carlton gave a "concrete example" which he also employed to register an important proviso:

... suppose that a monopolist of operating systems initially ties application programs to its system to prevent new applications programs from developing.

In subsequent periods, entry of new operating systems would occur if there existed a stock of independent application programs. But, by assumption, such programs don't exist because Firm 1 prevented their development by foreclosing the initial market to them. For such models to have empirical relevance, the disadvantage that Firm 1 can impose on Firm 2 should be large relative to the time it takes Firm 2 to overcome the disadvantage (670).

The recent *Microsoft* case involving the bundling of an Internet browser with the "Windows" operating system has important similarities to Carlton's example.³⁴

We have so far implicitly dwelt on the possibility that a conglomerate merger involving portfolio effects that facilitates tying of complementary goods could create problems for competition essentially through raising the costs of actual or potential rivals. It is also possible that tying, or more likely, bundling could harm buyers by reducing the profitability of entry into any one of a number of products sold together. This is the focus of two articles by Barry Nalebuff.³⁵

Nalebuff (1999) considers the incentives a monopolist in two products would have to bundle them. The two products need not be complements. Nalebuff argues that the profits obtained through bundling as a type of price discrimination may pale in significance compared with the benefits of deterring new entry into presently monopolised products. Implicitly then, Nalebuff is relaxing the assumption that the sellers enjoy unassailable market power in any of the bundled products.

Nalebuff stresses that in contrast to its use as a type of price discrimination, bundling as an entry deterrent works best when there is a positive rather than a negative correlation across consumers in their valuations of the bundled goods.³⁶ He points out as well that although a successful tying strategy requires some means of credibly committing to the practice, that issue may not arise in bundling, at least not under the circumstances explicitly treated. This is because bundling could prove to be the profit maximising strategy even if it fails to deter entry. Further detail concerning the Nalebuff (1999) model, which deals with both pure and mixed bundling, can be found in Appendix B.

In the concluding section of Nalebuff (1999) we read:

Although creating a bundle doesn't stop competition, it forces competitors to play the game bundle against bundle. A firm that has only some components of a bundle will find it hard to enter against an incumbent who sells a package solution at a discount. This will be especially true when the consumers have positively correlated values for the components of the package *or* when the components are complements. Bundling also softens the harm done by a one-product (or limited line) competitor. The rival takes fewer customers away and prices don't fall as far (20, emphases added).

Bundling as modelled in Nalebuff (1999) provides a possible explanation of why a conglomerate merger combining products in which there is already considerable market power could consolidate that power. That does not mean, however, that such a merger would be detrimental to ultimate consumers. After all, Nalebuff's model predicts a price drop at least for buyers purchasing the bundle. In addition, to the usual complexities of assessing the welfare effects of the implicit price discrimination, the Nalebuff model also involves a trade-off between reasonably certain immediate price drops and more hypothetical longer term price drops that might have occurred had bundling not been used to discourage new entry. Moreover, the significance of the entry discouraging effect critically hinges on how great a handicap is imposed by obliging new entrants to simultaneously enter several markets instead of being able to enter just one, or just one at a time. The same is true, of course, as regards the entry deterring effects of tying hence the crucial welfare significance of the degree of durable market power in the tying product.

An example of the kind of analysis required to more fully explore the entry discouraging effect of tying/bundling was provided by Choi and Stefanadis (2001). Their model featured a monopoly supplier of two complementary component products. The assumption that entry was possible into either good but only through a process of costly, risky innovation led to the following observation:

... the tying of two complementary components by a monopolist credibly makes entry in one component completely dependent upon success in the other. An entrant can gain access to consumers and earn a positive profit only if the entrant in the other product is also successful. Tying, thus, makes the prospect of investment less certain, reducing the entrants' incentive for investment and innovation.³⁷

Nalebuff (1999) does not examine situations in which there is something less than monopoly power in each of the bundled products. This gap is partially filled in a "sequel" focusing on complements (*i.e.* a special case of positive correlation across consumers in the values they place on bundled goods). The model presented in Nalebuff (2000) is briefly described in Appendix B. Nalebuff (2000) concludes with:

As powerful as bundling is to a monopolist, the advantages are even larger in the face of actual competition or potential competition. Selling products as a bundle can raise profits absent entry, raise profits even against established but uncoordinated firms, all the while lowering profits of existing or potential entrants and putting these rivals in the no-win position of not wanting to form a competing bundle. The only real disadvantage of bundling is the potential cost of inefficiently including items consumers don't desire. This is less important when the items are complementary and when the marginal cost is essentially zero, as with information goods. Thus, we can expect bundling to be one of the more powerful and prevalent tools, perhaps we should say weapons, in our information economy.

This conclusion might require considerable modification if one abandons the assumption that each component is produced by no more than two firms. It is also worth pointing out that Nalebuff found that when the prospective bundle is reasonably small, consumers could be better off as a result of bundling. If this generalises beyond the specific circumstances of Nalebuff's model, the small numbers effect could be highly important in the context of thinking about actual conglomerate mergers involving portfolio effects. The potential bundles in such mergers might be quite small. It is also worth noting that Nalebuff did not consider efficiency gains that bundling might facilitate. Finally, Church and Gandall (2000) cast some doubt on the robustness of Nalebuff's deduction that once the first bundle of complementary products is on the market, it will not pay for rival complement producers to match that bundle.³⁸

This is a good place to note that certain realities of retail distribution can effectively make products complements even when final consumers do not view them as such. Consider, in particular, the situation of a group of products typically sold in the same type of retail outlet. Let us assume that from the consumer's perspective these products are neither complements nor substitutes. Suppose further that for some reason (perhaps fixed costs), retail outlets must stock a broad range of products in order to stay in business. Specifically, let us assume that the typical retail outlet's break even sales volume cannot be reached unless the retailer has all or almost all of the range of certain best selling products, *i.e.* so-called "key" or "must have" products. One or more sets of such key products constitute groups of complements from the point of view of the retail outlets. That point may take on competition policy significance if a merger results in a considerable reduction in the number of competing sets of such complements, especially if there are also real economies in retailers concentrating their purchases on a single supplier.³⁹ Under these conditions, a conglomerate merger uniting a sufficiently large number of key products could grant the merged company the power to engage in full line forcing and/or to require retailers to practice exclusive dealing.

Full line forcing and exclusive dealing do not always harm consumers, especially if the practices rest at least in part on real economic efficiencies. The probability of harm is significant, however, if the affected retailers have no effective competitors. In that case, consumers patronising the targeted retailers could be harmed by reduced variety and higher prices. It could also happen that rival suppliers lose a sufficient part of their business that they are forced to exit. If that happens to a sufficient number of the suppliers' rivals, consumers patronising other retailers could also eventually be harmed. The probability of such welfare reducing full line forcing and/or exclusive dealing could be important for certain strongly branded consumer goods.⁴⁰

The models examined in this sub-section of the paper, and further described in Appendix B, point to the possibility that, through facilitating tying or bundling, a conglomerate merger involving portfolio effects could assist firms in foreclosing and/or discouraging entry not just in one market but in two or possibly more. In order to actually have such an effect, however, considerable market power in at least one of the affected markets appears necessary.⁴¹ In addition, the entry deterring power of tying and bundling strategies depends on there being a strong positive correlation across consumers in the valuations they place on the affected products. Strong complementary relationships would satisfy that requirement but would also create an offsetting economic welfare benefit because the merger would internalise the positive effects of reduced prices in either of the complements. It would also internalise the advantages of improving the interaction of complements in ways that buyers could not easily realise for themselves, and perhaps lead to other economies of scale or scope ultimately benefiting consumers.

As with earlier concerns about the price discrimination aspects of tying and bundling, a highly fact intensive analysis is required to assess the risks to competition posed by potential tying/bundling facilitated by a conglomerate merger involving portfolio effects.⁴²

We have now seen that a conglomerate merger involving portfolio effects could lead to post-merger tying/bundling that could possibly have anti-competitive effects by virtue of excluding or restricting potential (non-party) competitors. For that possibility to be a significant probability, it is first necessary that there be significant pre-merger market power in the united products and, in the case of bundling, low marginal costs. It is also necessary that the products being merged be either complements or the kind of products for which there is a high positive correlation across consumers in the values they assign to each. These necessary conditions might be satisfied, for example, in certain information product markets.⁴³

Bundling facilitated by a conglomerate merger, could well mean that the bundled product would be sold at a lower price than the combined pre-merger prices for the component products. This is particularly probable in the case of mixed bundling, *i.e.* the typically more profitable, hence more likely form of bundling. Despite the clear benefit to buyers occasioned by an immediate drop in prices, competition authorities might still have the power and desire to block or condition the merger. This would only be the case, however, if the bundling is expected to lead to a rise in price of the unbundled components (*i.e.* assuming mixed bundling), and/or will result in excluding or restricting competitors to the point where buyers are eventually harmed by prices rising above pre-merger levels. A rise in the price of the unbundled components would exacerbate the price discriminatory effects of mixed bundling, but as already noted, price discrimination may or may not reduce economic welfare. To justify a decision to block or

condition the merger because of its exclusionary/restrictive effects *vis-à-vis* competitors, all the following conditions should be satisfied:

- existing or potential rivals cannot offer a competing bundle;
- existing rivals must exit the stand-alone product markets;
- once rivals have exited, the bundling firm has the power (*i.e.* is unconstrained by new entry and/or countervailing buyer power) and incentive to raise the price of the bundle, for a considerable period of time, above the sum of the pre-merger prices of the products combined;⁴⁴ and
- what buyers initially gain through prices set below pre-merger levels is less than what they later lose through paying higher than pre-merger prices.⁴⁵

In the absence of one or more of these conditions, bundling facilitated by a conglomerate merger involving portfolio effects should not have a net harmful effect on buyers even if it excludes/restricts competitors.

5. Efficiencies of conglomerate mergers involving portfolio effects

Just as the anti-competitive effects of a merger are necessarily bound up with actual or potential relationships between the merging parties, so are any efficiencies that could be counted as mitigating such effects. Although conglomerate mergers by definition do not involve vertical links or horizontal market overlaps, that does not mean they unite completely unrelated businesses. There is a potential for efficiencies in terms of raising capital but these are likely insignificant in the case of acquired companies that are already very large and enjoying favoured access to capital markets. There could also be economies of scale or scope in production. In addition, when a conglomerate merger combines complements, as frequently happens when portfolio effects are present, it could significantly lower the risks of making sunk cost investments to enhance complementarity through customisation. Separate entities, especially entities having considerable market power, might be reluctant to increase their dependence on one another through such sunk cost investments.

In many conglomerate mergers, the most important economies may well arise in regard to marketing, including distribution functions. This is particularly true of conglomerate mergers involving portfolio effects since these necessarily include some commonality in customers being served by the merging parties. Some commentators even equate portfolio effects with efficiencies arising from serving the same set of customers. For example:

A wide range of products is not always an indicator of dominance. It should only be so when it allows the firm in question to obtain significant cost savings by exploiting economies of scope, or when there are consumers interested in purchasing the whole range of products. In this case, a company offering the full range will reduce the transaction and supply costs for the customers and will also

be able to maximise its promotion campaigns (by, for instance, offering discounts across the range). This advantage for a firm offering a full range of products is sometimes referred to as a “portfolio effect”. In cases where such effects do not exist, the fact that a company is present in different product markets does not say anything about its dominance in one of them.⁴⁶

Efficiencies in conglomerate mergers involving portfolio effects sometimes take a special twist in that they are realised by customers rather than sellers. Such efficiencies are more likely to produce an increase rather than a decrease in prices, but such an increase should not necessarily be equated with anti-competitive effect in the sense of a reduction in consumers' surplus. In essence, the merger makes it possible to offer a new type of product or at least a significantly higher quality product, and raises an issue as to what the benchmark pre-merger price ought to be in measuring anti-competitive effect. Such efficiencies can be illustrated with an excerpt from the European Commission decision relating to the *ATR/de Havilland* merger which had aspects of a conglomerate merger involving portfolio effects (referred to in the decision as “range effects”):

It appears that, in the sector concerned, having a complete range of products would give *ATR/de Havilland* a significant advantage in itself. From the demand side, airlines derive cost advantages from buying different types from the same seller...

According to a study submitted by the parties, it is argued that the inability of a manufacturer to offer a full range of seating capacities under the same umbrella may harm the demand for other existing aircraft of that manufacturer. This logic flows from the fixed costs borne by the carrier for each aircraft manufacturer dealt with by that carrier. These costs include the fixed costs of pilot and mechanic training as well as the costs of maintaining different in-house inventories of parts and the fixed costs of dealing with several manufacturers when ordering parts stocked only by the individual manufacturers themselves...⁴⁷

6. Protecting competition by protecting competitors?

It is possible that conglomerate mergers could harm consumers by increasing the probability of predatory pricing. For example, a concern about possible predatory pricing appeared to play a role in the European Commission's decision to block the *ATR/de Havilland* merger.⁴⁸

It is true that through creating opportunities to cross-subsidise and lowering costs of capital, some conglomerate mergers, particularly those uniting firms of vastly different sizes, may increase abilities to predate. Those same mergers do not, however, necessarily increase incentives to do so. Incentives to predate depend critically on an ability to recoup any short term opportunity losses imposed by the strategy.

Scherer and Ross (1990, 190) noted that the US had seen some cases where conglomerate mergers were blocked because of predation concerns, but "... the predation doctrine was attenuated in later decisions under other sections of US antitrust law, and the so-called deep pocket challenge to conglomerate mergers has fallen into disuse".

Quite apart from predatory pricing, it is possible that a conglomerate merger could yield a price drop that initially helps consumers but eventually harms them. As earlier noted, such a price reduction could result either from efficiencies specific to the merger,⁴⁹ or from the effects of joint pricing of complements (or analogous effects arising from a commitment to tie/bundle).

The paradoxical result that internalised complementarities (or analogous effects) and/or increased efficiency associated with a conglomerate merger could actually have a net detrimental effect on consumers would only materialise under a number of highly restrictive conditions:

- the merged firm will enjoy such significant internalised complementary pricing (or analogous) effects and/or efficiencies from the merger that it finds it profitable to drop prices below pre-merger levels in at least one market whether or not it expects that price drop to induce competitors to exit (*i.e.* the price drop cannot be prohibited as predatory pricing);
- neither rivals nor new entrants can match the merged firm's new costs;
- rivals will exit;
- buyers cannot use countervailing power to hold prices at or below pre-merger levels;
- firms will not enter or re-enter the market in response to price increases above pre-merger levels;
- the merged entity finds it profitable to raise prices above pre-merger levels;⁵⁰ and
- what buyers initially gain through prices set below pre-merger levels is less than what they later lose through paying higher than pre-merger prices.

These seven points would probably be difficult to prove in relation to a conglomerate merger involving portfolio effects.

Some commentators have taken the view that the European Commission's prohibition in the *General Electric/Honeywell* merger turned in part on what the commentators considered to be ill-founded concerns about harm to competitors.⁵¹ The European Commission's press release relating to this decision did not explicitly mention this issue.⁵² Moreover, in a subsequent speech, Commissioner Mario Monti addressed the question: "Is it true that, in applying merger control,

the Commission cares more about competitors than customers?" His answer, in part, stated:

Actually, the goal of competition policy, in all its aspects, is to protect consumer welfare by maintaining a high degree of competition in the common market. Competition should lead to lower prices, a wider choice of goods, and technological innovation, all in the interest of the consumer.

Our merger policy aims at preventing the creation or strengthening of dominant positions through mergers or acquisitions. Such a market power produces competitive harm, which manifests either directly through higher post-merger prices or reduced innovation or, indirectly, through the elimination of competitors, leading ultimately to the same negative results in terms of prices or innovation.

Let me be clear on this point, we are not against mergers that create more efficient firms. Such mergers tend to benefit consumers, even if competitors might suffer from increased competition. We are, however, against mergers that, without creating efficiencies, could raise barriers for competitors and lead, eventually, to reduced welfare.⁵³

7. Alternative remedial approaches – *ex ante* versus *ex post*

Depending on a country's legal regime, it may be possible to apply an *ex post* rather than an *ex ante* approach (i.e. conditioning or re-structuring the merger) to address potential anti-competitive effects arising in conglomerate mergers involving portfolio effects.⁵⁴ By *ex post* we mean that a merger could be permitted despite some concerns about potential anti-competitive effects. The feasibility of using abuse of dominance provisions to catch various exclusive practices in situations where market power in one market is being used to strengthen market power in another has already been demonstrated in a number of European Commission decisions.⁵⁵

Before comparing the *ex post* and *ex ante* approaches it is well to review the objectives of merger remedies. Parker and Balto (2000) identified three:

- The foremost obligation of antitrust enforcers is to make sure that a merger does not reduce competition to any significant extent...
- A second objective is to select a remedy that will preserve competition with as much certainty as possible. The risk of inadequate relief, or the burden of untimely relief, should not be borne by consumers.
- The third objective is to preserve the efficiency-enhancing potential of a merger, to the extent that is possible without compromising our obligation to preserve competition.

They also touched on what the objectives do not include, and admitted the need for tradeoffs:

The (US Federal Trade Commission) is not a market regulator. Apart from enforcing the prohibitions that are contained in the antitrust laws, our job is not to regulate or prescribe the market behaviour of firms. That is a function of the competitive process. Nor are we industrial planners. Our obligation is straightforward and simple – make sure that the post-merger world is every bit as competitive as the one that existed before the merger. Of course, nothing in the real world is ever that simple. Tradeoffs and judgement calls need to be made.

These views are probably shared by most if not all OECD competition authorities.

An *ex post* approach has the distinct advantage of permitting a competition authority to assess anti-competitive effects of a merger in an actual rather than hypothetical setting. It may suffer, however, from two disadvantages which can be stated as questions: would the anti-competitive effects be detected; and would a satisfactory remedy be available post-merger?

Generally speaking there is a high probability that competitors could be relied on to bring anti-competitive effects to the attention of competition authorities whenever those effects depend on restricting or eliminating their power to compete. Such reductions in competition are at the heart of allegations that tying/bundling and a number of other exclusionary practices could be anti-competitive. Customers could also be expected to complain about anti-competitive effects of certain behaviour.

On the adequate remedy point, it must be noted that it may be difficult to undo a conglomerate merger involving portfolio effects. This is especially true if the merger united complementary products and there has been significant post-merger customisation to improve their complementary properties. Without an attractive structural option, a competition authority might be forced into the position of becoming a type of post-merger regulator should anti-competitive conduct appear. For example, where a firm is engaging in mixed bundling and rivals are relying on it in order to provide competing bundles, one can expect continuing allegations that rivals are being subjected to both overt and subtle discrimination. In such situations, a competition authority could find itself being pushed towards preserving competitors rather than protecting competition.

An *ex post* rather than *ex ante* approach was advocated in two critiques of the European Commission's decision in the Guinness/*Grand Metropolitan* merger case. After noting that it is difficult to distil the tying theory into practical policy guidance, Baker and Ridyard (1999, 183) state:

This difficulty raises the question of whether tying is an abuse which is amenable to *ex ante* intervention through merger policy or whether it should

be controlled *ex post* using other tools of competition law. The introduction of “portfolio power” theories into merger control certainly blurs the distinction between the control of market structure and the control of firms’ behaviour.

Heimler (1999, 8) was more categorical in his critique:

... a concentration should be prohibited only if the increase of market power that it creates is so widespread that only a prohibition could eliminate it. On the other hand, if the increase of market power is not structural, but it is related to a specific practice, then the merger should be let through and the abusive behaviour be addressed *ex-post*. Otherwise it is like banning the sale of Ferrari cars, because it is highly probable that drivers will not respect the speed limits.

The European Commission’s more recent prohibition of the *General Electric/Honeywell* merger has elicited similar criticism.⁵⁶

On the other side of the Atlantic, there is a recent case showing mixed support for at least acknowledging that an *ex post* remedy is available in cases where mergers raise potential exclusion concerns. The Federal Trade Commission, by a split vote, decided not to challenge PepsiCo’s recent acquisition of Quaker Oats. The two Commissioners voting to allow the transaction declined to treat it as a horizontal merger and noted:

While merger law may be the first line of defence, it is not the only line. The Commission still has the ability to address conduct in the post-merger world by all players in the industry. In light of the structure of the soft drink industry, the difficulty of entry into that business, and the presence of competitive practices that may tend to protect incumbent firms at the expense of newer rivals, we remain concerned about competitive conditions across the entire industry. We urge the Commission to continue to monitor the industry carefully, focusing not only upon the parties to the proposed transaction at issue, but on all industry participants. More specifically, we believe the Commission should assess current and future practices of industry participants including, among other things:

- the extent and effects of any exclusionary practices that may handicap a rival firm’s ability to enter into the soft drink business or to obtain highly coveted shelf or “cold vault” space in retail channels;
- whether soft drink industry participants enter into exclusive contracts with retail outlets, restaurants, businesses, municipalities, or other institutions, and whether those contracts unreasonably foreclose competition; and
- whether any of these or other soft drink industry practices have the effect of raising prices either at the wholesale or retail levels, reducing product variety and customer choice, or otherwise reducing the availability of such products to consumers.

If the Commission concludes that competition is threatened as a result of any such practices, it should seek appropriate relief against any firms engaged in anti-competitive conduct, including, if necessary, post-acquisition divestitures.⁵⁷

When the anti-competitive concerns raised by a conglomerate merger involving portfolio effects turn on the possible exit of competitors, there are perhaps still stronger reasons for tilting towards an *ex post* approach. Kolasky and Greenfield (2001, 29) noted:

... range effects theory denies customers certain and immediate lower prices and better products based on speculative, long-range concerns that competitors might someday leave the market if they cannot match the merged company's offerings, and that the merged company might then exercise market power if actual or threatened entry did not constrain it.

For good reason, both EC and US merger reviews have traditionally focused on likely short- or medium-term effects rather than distant possibilities. It is, for example, no answer to antitrust concerns to argue that entry in five or ten years will restore competition; consumers will suffer in the meantime and entry far down the road may prove a mirage. Similarly, it makes no sense to deny consumers immediate benefits from an efficiency-creating deal based on long-range concerns about competitor marginalization or exit that may never happen.⁵⁸

In terms of supporting an *ex post* versus *ex ante* approach to the review of conglomerate mergers involving portfolio effects, the preceding pair of comments should be balanced with considering exactly what an *ex post* approach would involve should post-merger conduct appear to be pushing a less efficient competitor out of business. How many competition authorities would be confident about taking steps to protect such a competitor?

8. Policy Conclusions

Without repeating the main findings presented at the beginning of the paper, we wish to draw the reader's attention to some general policy conclusions concerning the portfolio effects concept applied to conglomerate mergers.

Conglomerate mergers involving portfolio effects deserve greater scrutiny than is normally devoted to other types of conglomerate mergers. This is primarily because the presence of portfolio effects increases the likelihood that a conglomerate merger might facilitate anti-competitive tying or bundling. This likelihood is particularly great if the merger unites products:

1. in which there was considerable pre-merger market power; *and*
2. which are either:
 1. complements; or
 2. display both low marginal costs and a high positive correlation across buyers in the values placed on the products.

Whether or not a jurisdiction explicitly applies the portfolio effects concept, conglomerate mergers having these two features merit something beyond a quick initial screening. Any subsequent analysis would have to consider barriers to entry, merger specific efficiencies, and the effects of internalising the pricing of complementary products or of products having the positive correlation we just referred to.

Conglomerate mergers involving the above two characteristics could also give rise to behaviour amounting to price discrimination. This should rarely constitute sole grounds for opposing a merger, particularly since price discrimination could increase instead of reduce economic welfare.

The portfolio effects concept arguably helps competition authorities to think in broader terms when assessing potential pro- and anti-competitive effects of certain conglomerate mergers. There are certain drawbacks, however, that should be borne in mind.

Because “portfolio effects” is an umbrella concept, there is a danger of it being invoked to justify blocking or conditioning a merger having a number of potential exclusionary effects, none of which can be convincingly enough established to be the sole justification for opposing a merger. The accent must remain on establishing a high probability of harm to consumers rather than on demonstrating that there are several ways in which such harm might occur. And that probability needs to rest not just on ways the merger enhances ability to act in an anti-competitive fashion, but also on there being a sufficient incentive to do so.

Many of the anti-competitive effects allegedly arising from certain conglomerate mergers involving portfolio effects are more hypothetical and off in the future than the effects commonly cited as grounds for blocking or conditioning horizontal and vertical mergers. This raises a serious issue of whether an *ex post* remedial approach should be preferred to an *ex ante* approach in the case of conglomerate mergers involving portfolio effects. The best approach could well vary from case to case. It could also vary from one jurisdiction to another, *i.e.* depending on legal provisions and enforcement resources.

This paper has tangentially raised the following question. Would merger review be significantly clarified if vertical mergers were re-defined as mergers of complements? If that were done, most conglomerate mergers involving portfolio effects and raising significant competition issues would be classified as vertical mergers. That in turn might produce significant analytical synergies in screening and, if required, fully assessing mergers significantly raising the probability of anti-competitive exclusion/restriction of competitors. Perhaps this question merits further attention by the Competition Law and Policy Committee.

Appendix A

Excerpts from Two Additional European Commission Merger Decisions

1. Aerospatiale – Alenia/de Havilland (“ATR/de Havilland”)

In this decision taken in October 1991, the European Commission found there were separate product markets for planes having 20 to 39 seats, 40 to 59 seats and 60 seats and over. The merger included some overlap in the 40 to 59 seat market and would have conferred on the combined entity strong market shares in all three markets. Although the decision does not use the term “portfolio effects”, it makes extensive references to how the merged entity’s larger product range could produce anti-competitive effects. The following excerpt comes from the part of the decision dealing with the “Impact of the Concentration”:

... unlike the competitors, the combined entity would have all the advantages of a family of commuters to offer. This may give rise to the ability, *inter alia*, of offering favourable conditions for a specific type of aircraft in mixed deals. It may be conceivable that, for example, where an airline wants to acquire a small commuter of around 30 seats and a commuter of around 60 seats, ATR/de Havilland could offer special conditions for the ATR 72 (66 seats) when it is ordered with a Dash 8-100 (36 seats) where more competition is likely. The parties state that in practice there is no chance of mixed deals taking advantage of market power in one segment to sell in another. However, in comments introduced by economic consultants on the parties’ behalf, reference is made to the ability of the combined entity to package together regional aircraft. The parties themselves expect that the aggregation of ATR and de Havilland marketing and manufacturing forces “will certainly lead to an improvement of their position in North America and Europe among the regional aircraft producers”, so that the position of the combined entity would be stronger than that of ATR and de Havilland currently.

It appears that, in the sector concerned, having a complete range of products would give ATR/de Havilland a significant advantage in itself. From the demand side, airlines derive cost advantages from buying different types from the same seller...

According to a study submitted by the parties, it is argued that the inability of a manufacturer to offer a full range of seating capacities under the same umbrella may harm the demand for other existing aircraft of that manufacturer... This logic flows from the fixed costs borne by the carrier for each aircraft manufacturer dealt with by that carrier. These costs include the fixed costs of pilot and mechanic training as well as the costs of maintaining different in-house inventories of parts and the fixed costs of dealing with several manufacturers when ordering parts stocked only by the individual manufacturers themselves...⁹⁹

Increased bundling capability was not the only concern in this merger. Intertwined with that was the expectation that the merged entity would be able to offer customers certain important advantages whose flip side would be higher future switching costs for buyers, and

an increased probability of predatory pricing.⁶⁰ Later in the “Other general considerations” section of the decision, we read:

The consumers will be faced with a dominant position which combines the most popular aircraft families on the market. Choice will be significantly reduced. There is a high risk that in the foreseeable future, the dominant position of ATR/de Havilland would be translated into a monopoly. Both British Aerospace and Fokker, the two principal competitors in the markets of 40 seats and above, have stated that the concentration would seriously jeopardise the survival of the ATP and Fokker 50 aircraft. These two competitors expect that the proposed concentration would lead to ATR/de Havilland pursuing a strategy of initially lowering prices so as to eliminate the competitors at least in the key markets of 40 seats and above. Neither Fokker nor British Aerospace consider it possible for them to withstand such a price war. Consequently, both would leave the markets. In evaluating these statements, it is noted that such conduct could be rational since the proposed concentration would mean that ATR/de Havilland would exceed the threshold of market shares which would make such a pricing policy likely given that it would be the optimal profit-maximising strategy. Having established a monopoly, ATR/de Havilland would be able to increase prices without any competitive check.

With this perspective, the proposed concentration would become even more harmful to the customers over time as the dominant position translates to a monopoly.⁶¹

2. Boeing and the Hughes Space and Communications Company (“Boeing/HSC”)

This case involved the merger of a major firm active in the commercial aircraft, defence and space industries (including the production and launch of satellites) with an enterprise engaged in satellite-based services and satellite manufacturing. Despite the fact that the merger did not create overlaps in either satellites or satellite launch services, the Commission found it necessary to consider the possibility of anti-competitive effects arising out of combining these complementary products in which both companies enjoyed strong market positions. “Portfolio effects” were not referred to as such in the decision. The case is nevertheless a good illustration of portfolio effects as defined in this paper. The Commission identified six tying related potentially adverse effects of the transaction:

- Satellite makers seem to bid to customers with a mass margin. After the operation, HSC might design this mass margin so as to optimally fit with the payload capacity of Boeing’s launchers. This might make the offers of other launch service operators less competitive than Boeing’s.
- Some DIO contracts give the satellite prime contractor a certain flexibility as to the launch vehicle to be used. After the merger, HSC might try to have all those satellites launched on Boeing or Sea Launch vehicles.
- Launching a satellite requires prior integration work between the satellite and the launcher concerned. This integration may be performed on a case by case basis, but it appears to be also possible to develop general compatibility agreements between the launcher and the satellite family. After the proposed transaction, HSC might refuse to develop such compatibility agreements, which would increase the costs and time required for the integration of HSC satellites with launchers operated by third parties.
- HSC may refuse to provide third-party launch service operators with information relating to its next satellites or to satellite updates, so that those launch service operators cannot easily make their launchers compatible with those satellites.

- As a satellite manufacturer, HSC receives competitively sensitive information relating to the launch vehicles with which its satellites will be integrated. Although that information is usually protected by confidentiality clauses, HSC might use it to the detriment of third party launch service operators.
- In the longer term, HSC might design its next generation of spacecraft so that they fit with Boeing's launchers better than with other launchers. For instance, HSC might impose unique and proprietary interfaces for its satellites, so as to favour Boeing launchers. HSC might also design its satellites so that they can be launched in such a way that they last longer than satellites usually do.⁶²

Despite these concerns, the European Commission concluded, after canvassing buyers, that it would not be profitable for Boeing/HSC to induce satellite customers to use only Boeing launch services. Buyers simply put too high premium on being able to use a number of launchers rather than risk depending on just one.

Appendix B

Greater Detail Concerning Selected Economic Models Referred to in the Text

1. Adams and Yellen Model

Schmalensee (1984, S211) succinctly summarised this model as follows:

(There is) a monopolist producing two goods with constant unit costs and facing buyers with diverse tastes. The marginal utility of a second unit of either good is assumed to be zero for all buyers (so a maximum of one unit is sold to each consumer). The goods are independent in demand for all buyers, so that any buyer's reservation price for the first unit of either good is independent of the market price of the other. Thus the maximum amount any buyer would pay for a bundle consisting of one unit of each good is the sum of the two reservation prices, and buyers are completely described by the values of those two prices. Resale markets are assumed away.

Adams and Yellen identify three conditions which would be satisfied by "pure" price discrimination (presumably a situation where the monopolist sells each unit at a different price). Somewhat paraphrased, they are:

- complete extraction – no buyer realises any consumer surplus on his purchases;
- exclusion – no individual consumes a good if the cost of that good exceeds his reservation price for it; and
- conclusion – any individual whose reservation prices for a good exceeds its cost in fact consumes that good.

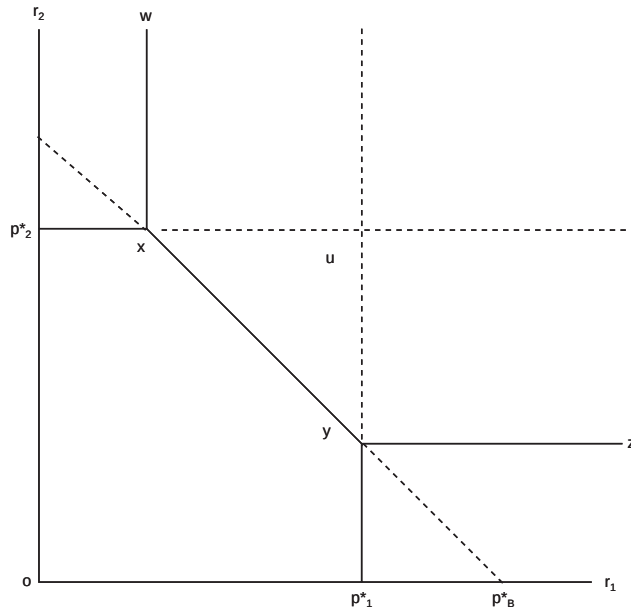
Applying these labels, Adams and Yellen noted that:

The chief defect of pure bundling (*i.e.* only a bundle is offered) is its difficulty in complying with Exclusion. The greater the cost of supplying either good, the greater the possibility of supplying some individuals with commodities for which reservation price falls short of cost... Thus pure bundling is preferred to simple monopoly pricing only if the greater profits accruing from more complete extraction or inclusion are not outweighed by the lower profits due to less complete exclusion. The more negligible are costs relative to reservation prices, the less of a problem this poses for pure bundling.

The mixed bundling strategy (selling components separately as well as bundled) is more profitable than its pure counterpart whenever Exclusion is violated in the pure bundling equilibrium... In general, *whenever the exclusion requirement is violated in a pure bundling equilibrium, mixed bundling is necessarily preferred to pure bundling* (482-3, footnote omitted).

Both pure and mixed bundling allow the monopolist seller to sort consumers according to their reservation prices and effectively charge different prices to them. Pure bundling sorts, however, into just two groups, those having a total reservation price greater than the

price of the bundle and those who do not. Mixed bundling goes further in permitting sorting into four groups: those who buy the bundle, those who buy nothing and those who buy just one or the other separately supplied goods. This was illustrated with the following diagram (*i.e.* Adams' and Yellen's Figure III at page 480):



Assume that with mixed bundling, the prices for goods 1 and 2 sold as components are p^*_1 and p^*_2 respectively. Assume further that p^*_b is charged for the two goods bundled together. Consumers having combinations of reservation prices located to the Northeast of WxyZ would buy the bundle. Those to the Northwest of point "x" would buy only the second good and those to the Southeast of point "y" would buy only good 1.

2. Schmalensee's extensions of the Adams and Yellen model

Schmalensee (1982) extended the Adams and Yellen model by considering what would happen if there were competition in one of the bundled goods. His concluding paragraph read:

In the analysis of tying contracts as metering devices, it is usually assumed that the two products involved are complements and that buyers with higher reservation prices for the tying product demand more units of the tied product at any price. This positive association between demands is exploited by selling the tied product above cost, thus capturing more surplus from those who value the tying product more. Here, in contrast, a negative relation between reservation prices in the population is exploited, and (the competitively supplied

good) is accordingly sold below cost (in the sense that the bundled price minus the stand alone profit maximising price for the monopolised good, is less than marginal cost of the competitive good). This permits extraction of more surplus from those who value it less and value (the monopolised good) more (71).

Under these circumstances, Schmalensee pointed out that bundling could well produce complaints from competing producers that the monopolist is engaging in below cost selling in order to monopolise their market. The monopolist could counter, however, that it is indifferent to making the product itself or buying it at cost from the competitive industry and might be able to point out that the total output of the competitively supplied good has risen.

In a later article Schmalensee (1984) returned to the assumption of monopoly in both bundled goods, but further developed the Adams and Yellen model by assuming a particular type of stochastic dependence in demand, namely "... that buyers' reservation price pairs follow a bivariate normal distribution" (S212). Under that seemingly plausible assumption, pure bundling compared with pure component pricing is likely to increase not just profits but also total economic welfare. The probability of a favourable outcome increases as the willingness to pay for both goods grows larger compared to the marginal costs of producing them. Schmalensee speculated that under other demand distribution assumptions, it would remain true that "... bundling permits more efficient extraction of surplus by reducing effective buyer heterogeneity..." (S229, emphasis added).⁶³ He was not as sure, however, that this would hold if one relaxed assumptions concerning: monopoly in both products; independent demand for the two products; or consumers purchasing just a single unit of both products.⁶⁴

3. Two models of foreclosure through vertical integration

Ordover *et al.* (1990) described foreclosure through vertical integration as follows:

Consider a market in which the supply of inputs is competitive before the merger and there are no production efficiency benefits gained from vertical integration. After the merger, suppose the upstream division of the now-integrated firm refuses to supply inputs to the rivals of its downstream division.

This foreclosure of rivals from these supplies means that remaining suppliers will face less competition. As a result, they may be able to increase their profits by raising their input prices to the unintegrated downstream firms. These higher prices benefit the vertically integrated firm. If rivals' costs of inputs are increased, they will be forced to reduce their production and raise the prices they charge in the downstream market. This reduction in competition allows the downstream division of the integrated firm to increase its market share and its price. Thus the profits of the vertically integrated firm can rise, even if there are no production efficiency benefits flowing from the vertical integration (127-128, reference omitted).

Ordover *et al.* identified six criticisms levelled against this "leveraging" theory, and addressed them in a model that assumed initial upstream and downstream duopolies producing differentiated products. To abstract from the effects of merger induced gains in efficiency, Bertrand competition was assumed. Based on their model, Ordover *et al.* concluded that vertical foreclosure could be profitable, and welfare reducing, provided the unintegrated upstream firm's gain exceeded the unintegrated downstream firm's loss. Under those circumstances the effects of the first vertical merger could not profitably be undone by a second parallel merger.

Ordover *et al.* considered two ways in which the essential inequality in gains could be guaranteed. One was that the integrated firm could make a price commitment to the unintegrated downstream firm in order to cap what the unintegrated upstream firm could charge. The other was the possibility that the upstream price could be kept below the critical threshold by pressure from "... an alternative (and inferior) competitive source of supply" (140).

Ordover *et al.* conceded that foreclosure would not necessarily be profitable and welfare reducing in a quantity-setting, homogeneous goods model. As for assuming an upstream oligopoly instead of a duopoly:

In that case, a single vertical merger would not confer complete monopoly power on the remaining upstream firms. While competition among them would naturally constrain the upstream price, reducing the profitability of foreclosure, such competition also would reduce the potential for an effective counterstrategy on the part of the foreclosed downstream firm. The necessary modelling is not entirely straightforward, however (140).

The Ordover *et al.* model was criticised for its assumption that the integrated firm could make a credible commitment to supply the unintegrated downstream firm at a price sufficiently low to rule out a defensive counter-merger. To meet that critique, Choi and Yi (2000) presented a reformulated model in which the integrated firm advantaged its downstream subsidiary by supplying it with a customised input. Without the merger, the upstream firm would have had no incentive to grant such an advantage because it presumably would not share in the gains realised by the downstream firm. This customisation strategy has the critical additional effect of producing an upstream cost heterogeneity between the duopolists, which reduces upstream competition and increases the profits of both upstream suppliers.⁶⁵ Since it would eliminate that heterogeneity, a defensive counter-merger by the unintegrated downstream firm would not be profitable.

4. Nalebuff (1999)

Nalebuff first considers pure bundling and explains how it could have two important effects on the profitability of new entry in a situation where the incumbent firm enjoys a monopoly in two products, A and B. The first is what he calls the "pure bundling effect". This is explained in the context of an incumbent selling A and B only as a bundle, and wanting to prevent entry into both products (*i.e.* the incumbent does not know which of them a new entrant would choose to produce). Nalebuff begins with the simplifying assumption that the bundle price is simply set equal to the sum of the two profit maximising prices that would be charged were the products to be sold separately. He further simplifies by assuming marginal costs of zero for both goods, stochastic independence as regards the reserve prices across buyers, and some assumptions allowing for simpler calculation of prices and profits. Under these simplifying assumptions, bundling cuts the profits of new entry into either product in half.⁶⁶

After demonstrating the "pure bundling effect", Nalebuff turns to the "bundling discount effect". This effect arises because with A and B sold as a bundle, the profit incentive to slightly lower the price grows because extra profits are realised on the increased sales of both goods. With the addition of the bundling discount, Nalebuff shows that the bundling induced drop in expected profits from entry is even larger than it would be with the pure bundling effect. He also demonstrates that were entry to occur, the incumbent's profits would be greater if it chose to continue to bundle than if it chose to discontinue the practice and compete product by product. That makes it unnecessary for the bundling firm to make a credible commitment to continue to bundle.

Nalebuff develops several important extensions to his model beginning with comparing mixed and pure bundling. Mixed bundling was found to increase profits for an uncontested dual monopolist but would not add much when a monopolist in one of the two goods has a rival in the other. In that case, it must price the monopolised component high enough to prevent its competitor from constructing a rival bundle. Nalebuff also noted that if marginal costs were greater than zero, some inefficiency would result (*i.e.* some goods would be sold to consumers whose reservation prices fall below marginal costs), but that significant gains remain to bundling.

Concerning the impact of allowing bundles to grow beyond just two goods, Nalebuff concludes that:

The discrete gains that come from the act of bundling two goods do not continue to grow when more goods are added to the bundle. Eventually there is a gain from creating a very large bundle but that gain is due to a third effect, the law of large numbers.⁶⁷

On the next page he added that:

Upon reflection, when the scope of bundling is modest, the strongest argument for adding another good to a bundle is to keep one step ahead of a potential entrant. An incumbent with a three-good bundle has less to fear from a potential entrant who can put together a two-good package. The third good prevents the incumbent from competing head-to-head and makes it harder for the entrant to gain share.

Nalebuff also explores the effects of positive and negative correlations in reservation values and deduced that positive correlations tend to increase the pure bundling effect while negative correlations tend to reduce it. He also considered the effects of complementarity, defined as arising when the utility of consuming A and B together exceeds the sum of the utilities experienced by consuming them separately. He found that the effects of such complementarity are separate from and potentially additional to any effects arising out of a positive correlation in reservation prices, *i.e.* complementarity tends to enhance the pure bundling effect. In contrast, if bundled A and B are substitutes, the pure bundling effect is reduced.

5. Nalebuff (2000)

The model in Nalebuff (2000) included the following assumptions: duopoly production of each of the complementary components (*i.e.* there are $2n$ firms where there are n complementary components; each pair of components is differentiated by something analogous to transportation costs; and perfect complementarity (*i.e.* the consumer must have one of each of the n complements). Within that framework, Nalebuff compares three possible forms of competition: component against component (no one bundles); bundle against bundle (everyone bundles); and bundle against components (only one bundle is offered). Nalebuff shows that bundle against bundle leads to lower profits than component against component competition. The intuition behind this is:

From the firms' perspective, the problem with bundle-versus-bundle competition is that the stakes are too high. Lowering the price of any one component increases the sale of all n components. The result is that the component prices fall down to such a low level that those incremental sales, all combined, are just enough to offset the loss in margin (7).

Where a co-ordinator (this could, but need not be a single firm resulting from a conglomerate merger) offers a bundle competing with n unco-ordinated firms each selling a single component, Nalebuff shows that profits for all firms are higher than they would be with pure component competition. The big winners are the first firms to form a bundle. Not only are

these first movers rewarded with high profits, they can be assured of keeping their winnings. Nalebuff shows that once a bundled product is on the market, profits would be reduced for all firms if the other n firms were also to bundle (*i.e.* thus introducing much less profitable bundle to bundle competition). The effects on consumers are ambiguous. As the number of complements (hence the number of products in the co-ordinated bundle) grows, the price per good at first falls then rises for the bundled offering. It rises constantly for the single component sellers. So there comes a point at which even consumers purchasing the bundle lose compared to no bundling at all.

6. Comments based on Church and Gandall (2000)

As with Nalebuff (2000), Church and Gandall assume components supplied by just two firms, *i.e.* duopolies. Unlike Nalebuff, however, attention is restricted to just two complementary products, *i.e.* hardware and software, rather than n complementary products. Another key difference is that Nalebuff deals with a stronger form of foreclosure. The first firm to bundle presents consumers with the choice of consuming the bundle or constructing their own bundle from the unbundled components supplied by rival firms. In Church and Gandall, the foreclosure effect is accomplished by a hardware firm vertically integrating into software, and subsequently making that software incompatible with its rival's hardware. This is a type of mixed bundling that at first leaves consumers the choice of:

- buying the integrated firm's offerings;
- purchasing the integrated firm's hardware and the rival software; or
- buying hardware and software from the unintegrated rival firms.

Intuitively it would seem that the unintegrated firms would be better off at this point than they would be with Nalebuff style first mover bundling. Nevertheless, under certain circumstances, Church and Gandall find that the unintegrated firms might improve their profitability by merging and making their software incompatible with the first mover's hardware.⁶⁸ In other words, we are left with some doubt about the generality of Nalebuff's finding that bundle to bundle competition is inferior for all firms than bundle against unbundled components competition.

Before leaving Church and Gandall, it is worth noting that, within their model, whenever foreclosure is an equilibrium outcome (*i.e.* whenever retaliation is not a viable option for the foreclosed hardware firm), the result is reduced economic welfare. The foreclosure might even produce monopolies in both hardware and software.

Notes

1. Computer software clearly has very low marginal costs. As for the correlation point, it may well be that, for example, the buyers who most value spreadsheet programs also rank highest among the buyers most valuing database managers. Note that these two products are likely neither substitutes nor complements for most buyers.
2. "Complements" includes both traditional complements and two products for which the buyers with the strongest demand for one member of the pair tend to be the same buyers having the strongest demand for the other.
3. American Bar Association, Antitrust Section (1992, 333).
4. This is sometimes referred to in terms of the products having a negative cross-elasticity of demand. That way of defining complements could, in the context of this paper be too restrictive. This is why we chose to focus on the concept rather than on how complementarity might be measured.
5. There is also the issue of the merger potentially increasing the probability of co-ordinated interaction. In the case of conglomerate mergers this potentiality is primarily bound up with whether the merger will increase multi-market contacts. Such effects do not appear to be more significant in conglomerate mergers involving portfolio effects than in the case of all other conglomerate mergers, which is why they are not further discussed in this paper.
6. Conglomerate mergers primarily motivated by a desire to reduce investor risk by smoothing earnings through the business cycle are excluded from this paper's notion of portfolio effects. Such mergers may be a means of overcoming certain imperfections in the capital market, but could also lead to other imperfections/inefficiencies of their own [see Scherer (1980)]. Discussion of those conglomerate mergers is outside of the scope of this paper.
7. The following extract from a 1998 European Commission report demonstrates the evolving nature of the portfolio and closely related "range effects" concepts, and shows as well that the concepts apply to both branded and industrial products:
The question of the potential impact of range effects on competition, which is particularly important with regard to daily consumer goods, such as drinks, arises in connection with the additional benefits that may accrue to the owners of dominant brand names. These advantages may be reflected in greater pricing flexibility and in a wide range of commercial strategy options. In the *Coca Cola/Carlsberg* and *Guinness/Grand Metropolitan* cases, the Commission considered the inclusion in a range of drinks of strong brands belonging to separate markets. *It concluded that the impact of such inclusion could give each of the brands in the portfolio greater strength on the market than if they were sold individually, and strengthen the competitive position of the portfolio's owner on several markets.*

In the second case, the consequences for potential competitors of owning a portfolio of high-profile brand names were also examined. The negotiating leverage resulting from ownership of dominant brands, which could, for instance, enable exclusive deals to be imposed, was deemed likely to raise additional obstacles to the market entry of new products.

Other range-related effects can also be noted in the industrial sector. For example, in the *Boeing/McDonnell Douglas* case, leaving aside the previously existing monopoly in the wide body jet aircraft segment (Boeing 747), the merger resulted in an additional monopoly in the smaller narrow-body aircraft segment, thus making Boeing the only aircraft manufacturer offering a complete range of large commercial aircraft. This position could not be contested by new potential entrants, given the extremely high entry barriers on the market, which was highly capital intensive [European Commission (1998*b*, 55-56, emphasis added)].

8. European Commission (1998*a*, paras. 99-103, deletions are in the original).
9. See European Commission (1997*a*).
10. Switzerland (2001, para. 8)
11. Migros and Coop are the most important retailers in the food sector in Switzerland with a combined market share between 40 per cent and 50 per cent. The reason that Nestlé and Migros are strong actual and potential competitors is that Migros produces most of the goods it retails.
12. Switzerland (2001, paras. 14-20, footnote in the original).
13. "Portfolio effects" are not expressly referred to in the press release relating to the decision. The European Commission apparently prefers to restrict that term to cases involving branded consumer goods. Published critiques of the decision refer to "range effects" [see Kolasky and Greenfield (2001)] and "conglomerate effects" [see Lexecon (2001)].
14. European Commission (2001).
15. Monopolies and Mergers Commission (1981, 5). The definition in American Bar Association, Antitrust Section (1992, 131) basically extends that definition to include arrangements where the buyer "... agree(s) that he will not purchase (the tied product) from any other supplier".
16. For further development of this point, see *ibid.*, pp. 5-7 and Carlton (2001).
17. United States Court of Appeals... (2001, 70) (Microsoft). The cited judgement carved out an exception to this. It required (at pp. 85-86) a rule of reason approach to assess the legality of bundling involving platform software markets.
18. There are echoes here of the asset specificity arguments favouring vertical integration.
19. See Adams and Yellen (1976, 476-477).
20. A "reservation price" is the maximum a buyer would be willing to pay for a single unit of a product when either there is no option to purchase more than one unit, or it would be impossible to do so. For example, a consumer can be said to have a reservation price for attending the evening showing of a particular film on a particular night at the local cinema.
21. The concept of a distribution of reservation prices across consumers broadly corresponds to what we earlier referred to as stochastic dependence in demand.

22. Such social losses would usually be even higher, and the bundling firm's profits lower, if pure bundling were substituted for mixed bundling.
23. See Varian (1989) for a general review of the difficulties involved in assessing the welfare effects of price discrimination.
24. This is analogous to eliminating a double marginalisation problem through vertical integration.
25. To explain the importance of there being buyers only interested in the tied product, Carlton (2001, 667-668) gave the following example, which he attributed to Robert Gertner:
 Imagine a monopoly resort hotel on an island where hotel workers live. By requiring that hotel guests eat only in the hotel, the hotel may prevent other restaurants from developing that would otherwise serve both tourists and natives. Although the tourists were already subject to the monopoly power of the hotel (through the room rate), local residents were not, and hence are harmed by the reduction in competition.
 In an earlier case, Carlton noted that tying could increase profits even in situations where all buyers purchase both tying and tied goods. Those are situations where price discrimination by the tying firm would not be possible without the tie, *i.e.* would be undone by arbitrage among buyers. See Carlton (2001, 665-666).
26. Specifically, he stated:
 One of the primary ways in which this can be accomplished is through product design and the setting of production processes, both of which may involve significant sunk costs. By bundling components of its system together or by making interfaces between the separately sold components incompatible with their rivals' components, firms can precommit to their marketing strategy...
 On the other hand, in a significant number of tying cases little more than an easily changed marketing decision seems to be involved (839).
27. When the tying and tied products must be consumed in fixed proportions, the monopolist might make more profits by allowing a competitor to supply a differentiated complement whose availability increases demand for the monopolised tying product.
28. See European Commission (2000). Appendix A of this paper contains some excerpts from the Commission's decision in this case.
29. See *ibid.*, paras. 81-82.
30. For a brief review of this case, which considers it to be a good application of criteria outlined in Whinston (1990), see NERA (2001).
31. As Whinston (1990, 850) noted in connection with discussing complementary products used in fixed proportions, it could happen that tying or bundling causes some firms offering differentiated products to exit. That could reduce the sales of the tying product (or one of the bundled products) if the tying/bundling firm is unable to replace those differentiated products.
32. Even if all these criteria are satisfied, the welfare effects of post-merger tying/bundling might be ambiguous if it is accompanied with welfare enhancing price discrimination. Whinston (1990, 839) stated that:
 The loss for consumers arises because, when tied market rivals exit, prices may rise and the level of variety available in the market necessarily falls. Indeed, in the models (presented), tying that leads to the exit of the monopolist's tied market rival frequently leads to increases in all prices, making consumers uniformly worse off. More generally, though, as is common in models of price discrimination, some consumers may be made

better off by the introduction of tying. The effect on aggregate welfare, on the other hand, is uncertain because of both the ambiguous effects of price discrimination and the usual inefficiencies in the number of firms entering an industry in the presence of scale economies and oligopolistic pricing.

This seems to be another example of the theory of the second best, *i.e.* welfare does not automatically decrease when a distortion is introduced in a market that already is distorted.

33. See Appendix B's discussion of Nalebuff (1999), *i.e.* what he refers to as the "bundling discount effect".
34. See Fisher and Rubinfeld (2001). Microsoft was apparently concerned that Netscape's browser could interface with a number of operating systems. That created a potential problem for Microsoft because the Netscape browser supplied applications handles. If a sufficiently large share of personal computers had Netscape installed, applications writers could design their software to work from its handles rather than from handles supplied by the Windows operating system. That in turn would reduce incentives for computer manufacturers and consumers to opt for Windows as their operating system since other operating systems, supplemented by Netscape, could also run the applications originally developed to work with Windows.
35. The key insight was foreshadowed in a model found in Katz (1989) which was essentially dealing with complementary products:
There are two inputs to downstream production, x and y . Initially, both are supplied by an upstream multi-product monopolist. Entry into production of x is completely blocked, say by patent protection. There is a single potential entrant into production of y , however. If the potential entrant chose to come in, the two firms play a differentiated products pricing game. Absent a bundling arrangement, there may be no way for the incumbent to deter entry into this market; the entrant may rationally predict that the incumbent would accommodate entry into the production of y . Suppose, however, that the incumbent can engage in bundling and set a package price for one unit of x and one unit of y that is lower than the sum of the price of x and the price of y . Given the proper demand conditions, this bundling has the effect of shifting downward the incumbent's (price-space) reaction curve in the y market to the point that entry becomes unprofitable. Intuitively, bundling can make the incumbent more aggressive in the y market because every additional unit of y sold as part of a bundle leads to greater profits from the sale of x as well. The ability to bundle may thus give the incumbent a credible threat to use against a potential entrant. Hence, a manufacturer may, in fact use bundling to "leverage" his monopoly in one market into a monopoly in another one when the second market would otherwise have had a less-than-perfectly-competitive structure (709).
36. With perfect negative correlation as regards products A and B: "... a one-product entrant has everything its consumers want... The markets for A and B are essentially different groups of consumers. In contrast, when A and B are positively correlated, the same group of consumers are buying both A and B and, thus, a one-product entrant can't satisfy its customers" (2).
37. Choi and Stefanadis (2001, 52-53).
38. See comments on Church and Gandall (2000) in Appendix B.
39. For example, delivery costs plus the costs incurred in receiving and stocking new supplies could be significantly reduced by concentrating on a single supplier. This is actually a special case of a more general phenomenon that Ayers (1985) refers to as "transaction complementarities". There could also be "economies of aggregation"

which could make it necessary to offer a minimum number of bundled goods in order to remain a viable competitor in things like internet service provision – see Bakos and Brynjolfsson (2000).

40. As our previous excerpt demonstrates, the European Commission cited such concerns as a reason for requiring the divestment of the Bacardi brand in the *Guinness/Grand Metropolitan* merger decision.
41. Baker and Ridyard (1999, 183) correctly point out that the theoretical models predicting “... harmful effects from tying typically assume that the product to which the competitive product is tied is a pure monopoly” (183). Whether bundling a group of “must stock” brands together would confer the requisite market power is an open issue, especially if the focus is on foreclosure rather than merely reinforcing existing market power.
42. Baker and Ridyard (1999, 183) observed that insofar as “portfolio power” refers to enhanced ability to engage in anti-competitive tying, such power cannot be lightly dismissed. Nevertheless, where tying is alleged, “... it should be described and analysed as such, and its likely effects should be evaluated in full recognition of the economic complexities in the tying literature”.
43. See note 1, *supra*.
44. Even if merged products are neither complements nor substitutes, a merger may still engender sufficient efficiencies and/or produce joint pricing of complements (or analogous effects) that cause profit maximising prices to remain below pre-merger levels despite the other assumed conditions being met. This is why we note that the bundling firm must also have the “incentive” to raise prices above pre-merger levels.
45. This depends in part on how soon rivals actually will exit the stand-alone markets which in turn depends on their marginal rather than average costs.
46. Faull and Nikpay (1999, 134). Although this paragraph’s context was the determination of dominance in abuse of dominance cases (*i.e.* Article 82), in the next paragraph the authors point out that the same ideas have been applied in merger cases (which are blocked if they create or strengthen a dominant position).
47. European Commission (1991*b*), para. 32. For other pertinent excerpts from this decision, see Appendix A.
48. See *ibid.* paras. 69-70 – these are included in the excerpt in Appendix A.
49. A variant of this would apply when a merger allows consumers to enjoy some “efficiencies” taking the form of a higher quality product, *i.e.* consequent on customisation to improve product complementarities. In this case, price may actually go up but the quality adjusted price might fall, especially where customisation adds only minimally to marginal costs.
50. The first five conditions listed refer to the ability to raise prices above pre-merger levels. The last addresses the possibility that due to the efficiency gains and/or joint pricing of complementarities (or analogous effects), the profit maximising price could nevertheless be below pre-merger levels.
51. See Nils von Hinten-Reed (2001), Kolasky and Greenfield (2001), and Lexecon (2001). It should be noted that Kolasky and Greenfield had previously represented GE and Honeywell, and counselled the companies in the final stages of the European Commission’s investigation of GE’s proposed acquisition of Honeywell. Lexecon Ltd. was one of General Electric’s economic advisers.

52. See the excerpt from this press release in Part III of this paper.
53. Monti (2001, 2).
54. In the interests of simplifying exposition, we omit discussing a mixed *ex ante* – *ex post* approach. A mixed approach would be one in which a merger is permitted conditional on the parties agreeing not to engage in certain practices having exclusionary effects. See Church and Gandal (2000) for a number of examples taken from some US vertical mergers.
55. See for example, European Commission (1991a), upheld in the decision of the Court of First Instance, Case T-83/91 *Tetra Pak International v. Commission* (1994) ECR II-755. See as well European Commission (1988) (*BPB Industries Plc and British Gypsum Ltd.*).
56. See von Hinten-Reed (2001, 3).
57. Swindle and Leary (2001). The two Commissioners who wished to block the transaction considered it to be horizontal in nature and stated:
Moreover, in light of the market positions of PepsiCo and Gatorade products, and in particular the potential threat to innovation posed by this transaction, the only appropriate course of action was to seek to block the acquisition pending further analysis through administrative proceedings. Mere monitoring and supervision might be insufficient to guard against these anticompetitive effects [Anthony and Thompson (2001)].
58. This is taken from an article criticising the European Commission's merger decision in *General Electric/Honeywell*. As noted above, Kolasky and Greenfield previously represented GE and Honeywell, and counselled the companies in the final stages of the European Commission's investigation of GE's proposed acquisition of Honeywell.
59. European Commission (1991b), paras. 30 and 32. Some of the same kind of customer savings derived from dealing with a single airplane manufacturer were also mentioned in *Boeing/McDonnell Douglas* which the Commission analysed as a conglomerate merger:
... where a large fleet in service is combined with a broad product range, the existing fleet in service can be a key factor which may often determine decisions of airlines on fleet planning or acquisitions. Cost savings arising from commonality benefits, such as engineering spares inventory and flight crew qualifications, are very influential in an airline's decision-making process for aircraft type selections and may frequently lead to the acquisition of a certain type of aircraft even if the price of competing products is lower [See European Commission (1997b, 41)].
60. See *ibid.*, para. 33.
61. *Ibid.*, paras. 69 and 70.
62. European Commission (2000, paras. 81-82)
63. According to Varian (1989, 629): “[Schmalensee (1984)] demonstrates that, in the Gaussian case (reservation prices are bivariate normal distributed), the standard deviation of the valuation of the bundles is always less than the sum of the standard deviations for the individual components. By reducing the dispersion of buyers' valuations, the monopolist is better able to extract the surplus from the population.”
64. Concerning relaxing the monopoly assumption, McAfee *et al.* (1989) showed that in their version of the Adams and Yellen model, bundling would be remain optimal from a profit maximising point of view for a pair of duopolists. Anderson and Leruth (1993) appear to question that view. They note that duopolists might suffer from the greater degree of price competition that could result from mixed bundling. This is better appreciated when it is noted that the profit maximising price for a bundle would usually be lower than the total of the prices of the components sold separately. See Nalebuff (1999).

Stigler's block booking example and some of the discussion in Adams and Yellen leave the impression that a negative correlation across consumers regarding reservation prices for bundled products is necessary for bundling to be a profitable strategy. Under conditions closely resembling the Adams and Yellen model, McAfee *et al.* (1989) have instead shown that bundling could be an optimal strategy for a monopolist even if there were no correlation at all in reservation prices across consumers. However, a perfect positive correlation would seem to rule this out [see Nalebuff (1999, 2)]. This is because such a correlation means that bundling would not reduce what Schmalensee referred to as "buyer heterogeneity".

65. The Choi and Yi model turns critically on their observation that:
For a variety of oligopoly models, competition is more intense when firms are more symmetrically positioned in terms of costs. Therefore, firms are collectively better off when their cost structure is asymmetric across firms (719).
66. The intuition behind this is as follows. Assuming the total market is normalised to a maximum of one unit sold and a uniform distribution of reservation prices (normalised to extend from zero to a price of one), the profit maximising prices for the goods were they to be sold individually are $P_a = P_b = 0.5$. At those prices, a half unit of each is sold and the total profit would equal, $0.25 + 0.25 = 0.5$. A new entrant into B (it could just as well be A) would charge just below 0.5 and earn a total profit of 0.25. Anticipated profits would be much lower, however, if A and B were initially bundled, even assuming they sold for a price of one. In that case, a new entrant into good B choosing to charge something just below 0.5 would not obtain sales of 0.5 units of B. Instead, the new entrant would only sell to buyers who simultaneously value good B above 0.5 and good A at less than 0.5 (*i.e.* roughly one quarter of all buyers). It would succeed in selling just $\frac{1}{4}$ unit and making a profit of $\frac{1}{8}$. People who value A at more than 0.5 (for example, 0.6) would consider the price of B obtained in the bundle as being something significantly less than 0.5 (*e.g.* $1 - 0.6 = 0.4$) and prefer to buy both A and B.
Concerning the assumption that reservation prices have a uniform distribution, Nalebuff comments that: "Over the entire class of symmetric, quasi-concave densities, the uniform density is the *least* favourable to bundling" (13).
67. Nalebuff (1999, 14). For further development of this or a related point see Bakos and Brynjolfsson (2000) which discusses bundling in the context of "economies of aggregation".
68. The circumstances appear to be that both hardware and software differentiation are sufficiently important to consumers. Church and Gandal note, at pages 28-29, that "... when the hardware products are *very* differentiated and the marginal value of software variety is small...", "foreclosure but not monopoly in hardware is the expected equilibrium outcome". They also note that when hardware differentiation is "very small" monopoly in both hardware and software is expected "... regardless of the marginal benefit of software..." (45).

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Summary of the Discussion

The **Chairman** opened the roundtable by noting the great deal of interest it had elicited. Fourteen written contributions were received. That number would probably have been larger had it not been for the fact, privately communicated to the Chairman, that in some countries there were divided views about what to say about portfolio effects in conglomerate mergers. The Chairman noted that this topic is highly interesting because we see a number of conglomerate mergers being reviewed using the portfolio effect theory, and also because there is obviously room for debate on how to do such assessments.

[Editor's note – the Chairman intended to begin by calling on the European Commission (EC) but due to some temporary difficulties, turned instead to Canada. This aide-mémoire nevertheless begins with the EC because the Canadian presentation fits better within the next section.]

1. Leveraging in conglomerate mergers

The **Chairman** recalled that the EC has had a number of important cases involving portfolio effects both in terms of mergers and in the application of Article 82 (abuse of dominance). The EC contribution is entitled, “Leveraging in Conglomerate Mergers”, and this is precisely what it treats. It looks at different types of tying that might be problematic: commercial tying based on pressuring down stream agents, commercial tying based on pricing incentives, and technical tying.

At the end of its contribution in paragraph 17, the EC states: “On the basis of the above description of the various forms of leveraging practices, it can be concluded that conglomerate mergers may produce anti-competitive effects under certain well defined circumstances.” This led to three questions from the Chairman beginning with a request for a clear and precise picture of what the very well defined circumstances were and how one could establish their existence. Second, if those conditions were realised, what could one say about the likelihood that the leveraging practices will take place? And third, if those leveraging practices were clear, easily detected and presumably qualified as abuses of dominance under Article 82, why should one worry about them in merger cases? Might they be better addressed *ex post* rather than *ex ante*?

A **European Commission** delegate began with some introductory comments setting out three reasons why the GE/Honeywell merger was omitted from the EC's written contribution. First, the decision was not yet published when the paper was drafted. This means that only the member states of the European Union and the US Department of Justice, who had received it from the parties, were aware of the text of the decision. The EC did not think it right to expose the argumentation in the required detail in the OECD roundtable when most delegations had not yet had a chance to study it. Second, the case is *sub judice*, i.e. it is before the European Court of First Instance. Of course being in court does not mean that one cannot discuss the main concepts, but it requires some restraint on the part of the EC. And finally, the heads of the US Department of Justice (USDOJ), the Federal Trade Commission and the European Union had agreed, less three weeks before the roundtable, to set up a joint working group to analyse in detail the real or perceived differences in analysis and to work towards convergence.

Turning to the Chairman's three questions, the EC delegate began with the precise conditions under which conglomerate mergers may produce anti-competitive effects. The EC sees those anti-competitive effects arising if a sequence of conditions is met, namely when mergers enable leveraging of market power, thus foreclosing rivals, thereby reducing consumer choice and ultimately, importantly, leading to a loss of welfare. Therefore, as a starting point, the existence of market power is a necessary condition for the ability, the likelihood and the profitability of leveraging practices. He noted that the GE/Honeywell merger would have united the dominant firm in one and the leading (not necessarily dominant) supplier in another market. The complementary character of the product markets is also of significance. Complementary products or close substitutes, such as, for instance, in the spirits or drinks sectors, which are sold to the same customers and are viewed by such customers as constituting an essential part of their requirements are more likely to create leveraging opportunities.

Turning to foreclosure, there are various ways in which foreclosure of rivals can take place. One is through strategic pricing. For instance, if bundling over a large portfolio is a chosen action, this may force competitors to play the game bundle against bundle. A firm with only some components of a bundle may find it hard to compete. In particular, in industries displaying high entry barriers, high sunk costs, long payback or break-even periods, intensive R&D and high investment costs, the competitors may be insufficiently able to counter the ability of the merged firm to leverage its broad and powerful market position. The existence of significant financial strength on behalf of the merged firm may in such a case be an additional, sometimes important factor. However, financial strength has to be analysed on a case by case and industry by industry basis to determine whether it is an important element of the overall analysis. This has nothing to do with "big is bad", and the Commission has never followed such a policy. Finally, a critical

analysis of possible efficiencies will have to be made. One has to ask whether efficiencies are real and likely to be structural – do they, for instance, reduce the marginal cost of producing and distributing the product in a sustainable way so that the benefits reach the consumer? In other words, the efficiencies must be merger related, real, durable and in case of doubt, must be demonstrable by the parties.

The Chairman's second question was, if these conditions are realised, what can one say about the likelihood that leveraging will actually take place?

The EC believes that once the ability to leverage market power is established, the required incentives to engage in leveraging practices will depend on whether the merged firm sees them as a profit maximising strategy, *i.e.* the best course of action from a company point of view in the circumstances. The abundant case law on such practices examined *ex post* under Article 82 suggests to the EC that when firms found themselves within the previously described market setting, they regularly have attempted and often succeeded in leveraging their market power from one market into another with a view to increasing profits by squeezing out rivals and ultimately extracting supra-competitive profits from consumers. However, there is no automatism from ability to incentives to action. For instance, in the *Boeing-Hughes* merger mentioned in the Secretariat's paper, competitors were concerned that the merged entity would use their powerful position in satellites to force customers to buy its launch services, a market in which the parties had a weaker market position. The Commission's investigation showed that buyers had their own preferences regarding launch vehicles and were not prepared to forego the possibility of choosing between a number of launchers. It would not therefore have been profitable for Boeing-Hughes to induce satellite customers to use only Boeing launch services, as they would have lost significant satellite sales on the way.

The Chairman's third question was if leveraging practices are clear and easily detectable abuses of dominant position prohibited under Article 82, why should one worry about them in merger cases?

The EC delegate considered this to be a false debate. While it is true that leveraging practices such as product tying, bundling and so forth, are *per se* abuses under Article 82, the same is true for abusive pricing behaviour resulting from market dominance. Would this mean that *ex ante* merger control should not bother to prevent the creation of dominance because in any case a subsequent abuse of such dominance can be caught by the corrective and punishing mechanism of specific *ex post* legal provisions? The EC believes the answer is clearly no. Leveraging practices may result in foreclosure of rivals, *i.e.* their gradual marginalisation or exit from the market or segments of it. In this respect it is hardly conceivable that the punishing mechanism of *ex post* instruments can do anything to prevent

such market foreclosure. In other words, the imposition of fines on the dominant merged firm, no matter how heavy these may be, cannot do anything to reinstate the competitive thrust and constraint of weakened or exiting rivals. Damage to competition will have already occurred and the legal system of prevention of the creation of market power, notably through an effective merger control policy, will have failed. In any event, the aim of *ex ante* merger control is to preserve competitive market structures with a view precisely to eliminating the need for more or less intrusive regulation of market behaviour with all its attendant evils.

2. Do we need a special treatment?

The **Chairman** pointed out that the Canadian submission focused on whether portfolio effects in conglomerate mergers are really a new issue or something that can be treated using traditional merger analysis. The Canadian contribution included the remark that: "... traditional merger analysis may be sufficient to analyse mergers between firms producing complementary products." Canada arrives at this conclusion by drawing a parallel between the treatment of conglomerate mergers on the one hand and the tools and treatment of horizontal and vertical mergers on the other. Canada observes, *inter alia*, that predatory pricing, leveraging, tying and bundling can also be issues in traditional vertical or horizontal mergers. The Chairman called for further comment on these points.

A **Canadian** delegate agreed that his country's paper aimed to provide some thoughts and observations on the question: can current merger analysis address a merger of complementary products? A very important part of merger analysis focuses on the impact the transaction will have on prices, and this brings up the matter of a possible Cournot effect arising from uniting complementary products. A merger of complementary products internalises the effect of a price reduction in one complementary good on sales of another. The result is that the merged entity may lower its prices post-merger and presumably increase its market share. This in turn could bring pressure to bear on competitors. In the longer run, it might even cause some of them to exit, and if there are high barriers to entry, one may well have a situation where the merged entity enjoys increased market power and an ability to raise prices. The same thing could apply to vertical mergers involving complementary products. There again a pricing externality is internalised. A double marginalisation problem is essentially solved by getting rid of the middleman and the mark up on the mark up. Once again the prediction could be that prices in the short term fall, but rise in the longer term if a sufficient number of competitors eventually exit and there are high barriers to entry.

Another area to examine in traditional mergers analysis is efficiencies, including the pricing efficiency associated with a Cournot effect. In addition, on the supply side in relation to mergers of both complements and substitute products,

there could be economies of scale and scope in production, sales, marketing and distribution. In the case of complements there could also be some advantages on the demand side, *i.e.* the benefits of one stop shopping.

The Canadian paper also examines some other areas of traditional analysis, barriers to entry for example, and refers to a couple of papers. One paper points out that multi-product firms can affect entry and exit decisions differently than single product firms. One author suggests that brand proliferation, for example, may deter entry at least in the case of substitutable goods. Another paper talks about multi-product monopolists in complementary goods having an incentive to deter entry more than a monopolist in substitutable goods. The Canadian paper also discusses inter-dependence in terms of price and tacit collusion, and deals as well with predatory pricing, and points out, essentially, that we can make no predictions based on whether a merger involves substitutes *versus* complements.

Turning to the area most often discussed in conglomerate mergers involving complements, *i.e.* monopoly leveraging, tying and bundling, the paper points out that the Chicago school initially produced a lot of scepticism about whether monopoly leveraging was actually rational and therefore something to be concerned about. More current thinking outlines conditions where vertical foreclosure is possible and can have anti-competitive effects due to strategic effects. Unfortunately, in this area there is not much literature on what to look for in relation to complementary goods. Most relates to substitute goods.

The Canadian delegate also drew attention to some measurement issues. These included determining whether goods really are complements. He also noted that in terms of bundling, sometimes it is hard to use current statistical techniques to define product and geographic markets, though the *Staples* case, for example, has produced some advances in this area.

The delegate closed by returning to the theme that the current framework of analysis in terms of pricing effects, barriers to entry, efficiencies and so on, can be incorporated into mergers involving complementary products. Moreover, anti-competitive practices such as predatory pricing, leverage, tying, bundling and so on can operate in any situation, not just post-merger, and in most jurisdictions there are explicit provisions to deal with those. In any event, these issues are not unique to mergers involving conglomerates and can be accommodated within existing merger analysis.

The **Chairman** noted that in contrast with the Canadian view, the Finnish contribution considers that a lot is gained by introducing the concept of portfolio effects into the realm of conglomerate merger review. The Finnish contribution states:

- It seems evident that, by using portfolio doctrine, one can reduce categorical market appraisal in a single specified market and focus attention on

actual comprehensive effects. In this respect, the portfolio doctrine contributes to the overall appraisal of concentrations. Thus, the competition test seems to better take into account consideration of the total effects the concentration has on competition.

The Chairman found this to be an interesting approach which, if he understood it well, holds that there are some limitations in the traditional analysis of horizontal mergers or vertical mergers where one has to define markets, perhaps in a somewhat arbitrary way, and then look at the effects market by market. In contrast, in the case of conglomerate mergers and a portfolio approach one can have a wider scope of vision.

The Chairman drew attention to Finland's *Omya/Mondo* case, a merger involving two suppliers of processed minerals for the paper, paint and plastic industries. Concerns were raised about the portfolio effects which could develop in the case of a merger involving a firm producing substitute products. So that is a bit different from one of the conditions mentioned earlier by the EC, namely the complementarity in the products. Indeed, the Finnish contribution stated: "Industrial minerals produced and processed by the parties to the acquisition were substitutive with respect to some markets, which resulted in Omya's portfolio benefits." The Chairman also remarked that the case seems to show that minerals for the paper and paint industry are industrial products for which brand effects may have been relatively unimportant. He asked the Finnish delegation to explain, *a*) its views on the general utility of the portfolio approach to mergers; and *b*) in particular in *Omya/Mondo*, what was the particular concern about portfolio effects in a merger involving substitutable products?

A **Finnish** delegate noted that *Omya/Mondo* was not a very illustrative portfolio effects case. Nevertheless it was examined from that point of view because, as the Chairman mentioned, both companies in the transaction were involved in producing different kinds of minerals to different paper industries. The target company, Mondo, was one of the biggest producers and suppliers of talc to the paper industry, and Omya was involved or active in producing calcium carbonate which is also used in the paper industry. These products were sometimes used in combination to treat paper. And the idea was that probably buyers of these products would source primarily from the merged entity, purchasing both inputs as a bundle. The products were partly substitutes, but they were partly complementary products as well. It was obvious, though, that very strong portfolio effects did not arise, partly because the buyers were very big paper companies which purchased from world wide sources. It followed that the merged entity would not be able to use talc, where they had quite a big market share, to tie sales of calcium carbonate. In any case, the transaction restructured an existing joint venture in a way that tended to create more competition, which was another reason the transaction was approved.

Turning to the Chairman's point about Finland's belief that the portfolio effect doctrine may be quite useful in handling certain merger cases, the delegate thought this is true because Finland is applying quite a strict dominance test. Finland examines mergers by first making appropriate product and geographic market definitions, and then analysing market shares in order to define whether the parties have market power and so on. And these tools coupled with the dominance test are not always enough to decide what is really happening in the markets. Finland thinks the portfolio effects concept may have some positive impact on that. Its experience is that strict and categorical market definition and market share appraisal are not always convenient and appropriate to define whether the merger has a negative impact on competition.

Finland concluded that the portfolio doctrine is useful, but one should also analyse whether there is something wrong with the dominance test.

The **Chairman** changed the direction of the discussion somewhat by noting that when the Japanese Fair Trade Commission (JFTC) looks at the problem of portfolio effects in conglomerate mergers, the Japanese FTC closely examines, "... the overall business capability of the merged firms". He asked the Japanese delegation to explain more about the overall business capability concept and to indicate whether it is also applied in assessments of horizontal or vertical mergers. The Chairman believed it referred to something more than market power. He also sought a description of the *Mitsui Petrochemical/Mitsui Toatsu Chemicals* merger.

A **Japanese** delegate stated that the Japanese Antimonopoly Acts treats conglomerate mergers in the same manner as other types of mergers. The JFTC examines whether a notified merger will substantially restrain competition in any particular field of trade. In order to clarify what types of mergers would substantially restrain competition, the JFTC has published merger guidelines specifying the factors considered in examining mergers and acquisitions, for example, market share, entry, efficiency, overall business capability and so on. If one looks at portfolio effects in conglomerate mergers, a close examination of the overall business capability of the merged firm would be made. If the overall business capability will increase after a merger, it is possible that other companies will have difficulty competing. The concept of overall business capability is wide-ranging enough to include portfolio effects, and would be applied to vertical and horizontal as well as conglomerate mergers. When determining overall business capability, in addition to market share, changes in the company group such as its abilities to procure raw materials, technological resources, marketing capability, access to credit, brand power and advertising capability are also be examined.

Increased overall business capability may enhance the power to restrain competition including through leveraging. However, the JFTC has never taken any legal measures with regard to mergers based on portfolio effects, and overall business capability is not a principal point in a merger examination.

Turning to the 1999 *Mitsui Petrochemical Industries Limited/Mitsui Toatsu Chemicals Incorporated* merger, it was conceivable that the transaction might have increased the overall business capability of the new company within the petrochemical industry as a result of greater integration of mutually related products. It might also have had a significant impact on competition in individual petrochemical products. But, there exists another leading firm, Mitsubishi Chemical Corporation, which ranks first in sales and ethylene production capacity. It was expected that sufficient competition would remain in the market, so that it was determined that an expansion of overall business capability would not pose a serious threat to competition.

The **Chairman** next cited the Korean contribution where it was noted that: "The Korean competition authority (KFTC) has kept an eye on conglomerate mergers and diversification attempts of chaebols because it realised that without effective regulation of conglomerate mergers, reckless expansion through reciprocal subsidies, cross guarantees, circular investment etc. will highly likely prevail in the chaebol dominated economy and give rise to competition-restrictive market structures." The Korean contribution goes on to state that to minimise the negative effects of conglomerate mergers among chaebols, the KFTC has prepared and enforces various institutional devices based on consistent principles. He called on the Korean delegation to explain more about the competition problem created by the conglomerate nature of the chaebols, and also the nature of the instruments used to tackle this problem.

A **Korean** delegate welcomed the chance to explain what is going on in Korean chaebols, the problems they present and government responses to them. He began by noting that the Secretariat's background paper contains a misunderstanding or portrays a limited understanding of the range or definition of the portfolio effect. It describes the portfolio effect as the only source of anti-competitive problems in conglomerate mergers. But this description fails to do justice to the competition restraining impact of conglomerate mergers.

Even where neighbouring markets are not involved, conglomerate mergers can bring about competition problems. For example, in Korea the top 30 chaebols own an average of 21 affiliated companies and have effectively diversified into approximately 16 industries on average. Despite this fact, the chaebols have maintained strong monopolistic power in many markets including service and product markets. For example, as of 1998, the industries where the top three firms had more than 75 per cent of sales account for some 60 per cent of Korea's mine and manufacturing industries and markets. This means very highly concentrated markets in Korea. In addition, the top 30 chaebols account for 70 per cent of the market dominant industries. The Korean market is therefore dominated by the top 30 chaebols. This has been facilitated by chaebol affiliates enjoying brand power flowing from sharing a well known name such as Samsung, and being able

to tap significant advantages through financing within the group. The financial advantages are quite significant because the Korean financial market lacks an effective banking system and inadequate prudential supervision. Korea also lacks effective labour markets, distribution net works and know-how markets.

The Secretariat report ranged from the complementary goods to substitute goods as examples of neighbouring or related items. The delegate wanted to expand consideration to cover totally different industries and thereby deal with a wider set of problems.

The Korean policy approach to chaebol problems has important *ex ante* and regulatory features and in some ways has a more macro than micro aspect. It stems from concerns to reduce the systemic risk of chaebols. Korea has witnessed the failure, for example, of the Daewoo groups. Daewoo had about sixty companies under its umbrella. After one or two companies failed, then the financially very healthy Daewoo Motors failed as well. This kind of systematic danger is very serious in Korea. Chaebols also create competition problems because they dominate Korean markets.

Chaebol groups exercise their own advantages or create competition problems by engaging in reciprocal subsidisation and by transferring money and man power from strong healthy affiliates to weak ones. This can communicate financial weakness to the group as a whole.

Korean chaebols can increase their market power through conglomerate mergers by: sharing a powerful brand; transferring capital, manpower and management skills (including sales forces); and by synergies coming from vertical or complementary relationships in chaebol products. The reason why Korean chaebols include anti-competitive effects going beyond straightforward portfolio effects is that Korea has a weak, very weak corporate governance, inadequate prudential supervision of the financial market, and a low level of openness to foreign investment.

The Korean contribution describes three kinds of policy tools applied to chaebols: regulation of conglomerate mergers; restrictions on undue subsidisation of intra-group transactions; and restrictions on economic concentrations. Korea's chaebol policies have been only partly successful. While the concentration of economic power has not been lessened, it has at least not increased. Importantly, Korea has recently fully opened its economy and has rebuilt its financial supervisory mechanisms. It also has introduced many kinds of institutional arrangements to improve corporate governance. Korea is now considering making changes in direct controls applied to chaebols.

The **Chairman** wrapped up consideration of general approaches to portfolio effects in conglomerate mergers by calling on the United Kingdom whose contribution basically argues that in some markets competition is led by portfolio based

firms. In other words, it is the competition between portfolio firms which really counts. The UK derives from this observation a set of three conditions under which conglomerate mergers with portfolio effects would be anti-competitive. And those three conditions are a bit different from conditions cited by the EU at the beginning of this debate. The Chairman called on the UK to talk about both its general approach to the portfolio problem and the conditions under which it sees portfolio effects as possibly anti-competitive.

After drawing attention to problems in defining conglomerate or portfolio mergers, a **United Kingdom** delegate noted that his country's general approach in such cases has been to see first of all whether a merger in some way facilitates raising rivals' costs. If it has that potential, there is then a need to question whether such increases actually matter, *i.e.* do they affect infra-marginal or marginal firms. Raising the costs of non-portfolio players might not be important in markets where the significant competition takes place among portfolio firms. Finally, the UK also considers efficiency gains from a conglomerate merger in a positive light and weighs these against any anti-competitive detriments in the merger.

One example the UK looked at involved a conglomerate merger in the advertising industry where the owners of various television stations sought to expand into radio stations. The company was seeking to assemble a wide portfolio of television, radio and outdoor advertising posters businesses. In that case four things were carefully examined. First it was found that there were benefits to providing a portfolio of products. Consumers were prepared to pay a premium to buy products together. The merger provided a higher quality product which was actually good for consumers and good for competition. And similarly the merger gave rise to economies of scope and scale on the supply side which again was thought to be good for competition. Consideration was then paid to whether assembling a larger portfolio would increase the incidence of anti-competitive tying or enhance the credibility of refusals to supply. These risks were seriously examined but rejected after a careful appraisal of the facts revealed that they were unlikely to materialise.

The only cases where the UK competition authorities took a dim view of conglomerate mergers involved situations where they led to a reduction in the number of portfolio firms in the market, *i.e.* there was, in a sense, a loss of horizontal competition. And a good example of that was cited in the UK's paper, again drawn from the radio industry. This case concerned a large radio operator in London that had a portfolio of radio stations and competed against a lot of small radio stations who collectively put together a portfolio. The merger "stole" one of the brands and made it more difficult for the smaller companies to provide a competing portfolio. So the merger had the effect of reducing the number of portfolio operators in the market from 2 to 1.

3. Market Definition

The **Chairman** opened this section of the roundtable by turning to Spain whose contribution contained, *inter alia*, a discussion of the *Proctor and Gamble/Tambrands* merger. At paragraph 28 of its contribution, one reads:

- ... the relevant market for the transaction was defined as the tampons market in Spain. This is one of the most important features of this case. Defining the relevant market in this way there was no addition of firms' market shares, as a result of the transaction; and so, the evaluation of the portfolio effect became extremely relevant.

This left two questions in the Chairman's mind. The first was whether when one arrives at a market definition that rules out finding the creation or strengthening of a dominant position, is a portfolio effect something used to try to evade the constraints of the law, *i.e.* to effectively change the standard? Is that what this paragraph means?

The second question concerned what would have happened if a wider market definition had been used and the merging parties had intended to tie or were likely to tie their products. Could that have been something that could have been picked up as a potential creation or enforcement of a dominant position under the Spanish law.

The Chairman noted a second interesting aspect to this merger. What happened was that Proctor and Gamble owned 50 per cent of Arbora which was the *de facto* exclusive distributor of Tampax, the main product of Tambrands, and was also distributing the products of Proctor and Gamble. So Proctor and Gamble through its subsidiary was distributing the products of its competitors. If the tying of brands was expected after the merger, why did it not occur before the merger?

A **Spanish** delegate noted that her country did not have much experience with portfolio effects beyond the two main cases included in its written contribution, *i.e.* *Proctor and Gamble/Tambrands* and *Sara Lee De Espana/Reckitt and Colman*. The first one related to the market for feminine hygiene products and the second to the market for footwear cleaning products. In both cases, the portfolio effects took place in highly concentrated markets. The delegate also mentioned that the definition of markets was rather complicated because the affected products were partly substitutes and partly complements. The market definition was in a way independent of the portfolio effect as such. In both cases, the assessments were conducted assuming that the usefulness of *ex ante* merger control is to preserve competitive markets, *i.e.* to avoid having to address post-merger anti-competitive behaviour.

Another Spanish delegate continued by addressing the question about the relationship between market definition and the assessment of portfolio effects

and offered a clarification of the paragraph cited by the Chairman. When it is said that market definition in the case was one of its most important features, this refers to the fact that the definition was highly controversial. The Spanish competition authority had to decide whether to define the relevant market as the whole feminine hygiene product or instead adopt a more restricted definition. After analysing the supply and demand substitutability relationships among the different feminine hygiene products, the Spanish competition authority concluded that the relevant market for this transaction was the tampons market. There was no intention in the written contribution to give the impression that the definition of the relevant market conditioned the assessment of the evaluation of portfolio effects. Given the relevance of brands in the relevant market, such effects would have appeared regardless of the market definition adopted. Therefore, the portfolio effects would not have been less important if the relevant market had been defined differently. The relevance of the portfolio effects in this case is given by the fact that, in the absence of horizontal overlapping of market shares, the existence of these effects was the only consideration that led the Spanish Competition Authority to authorise the transaction although subject to conditions.

Concerning the Chairman's second question, there was no evidence of Proctor and Gamble bundling or tying products before the transaction. Probably, it was not a profit maximisation strategy for Proctor and Gamble. But the absence of such practices, does not mean they are not going to appear in future. If such practices had existed, then the transaction would have been forbidden. Past events do not determine the decisions of the competition authority when it comes to merger control, which is by definition *ex ante* control. Through the transaction, Proctor and Gamble would become the owner of all brands of its portfolio, one that would contain must stock brands having the highest market shares in the feminine hygiene product groups. This would have increased its bargaining power *vis-à-vis* distributors. In addition, the relevant market showed a low degree of contestability due to the existence of significant barriers to entry. There were no alternative competing portfolios to counteract the situation, no powerful distributors. The importance of the Tampax brand in the market along with a low elasticity of demand, the requirement of high investment in advertising campaigns and the efficacy of publicity when protecting a large scale consumption product all led the Tribunal to the conclusion that Tampax's market share would remain at least as high as it was and that it would continue to be a must stock brand for retailers. As a result of the transaction Proctor and Gamble would gather in a portfolio the main brands in feminine hygiene products. It would have an ample portfolio that would allow it to set discounts so as to encourage retailers to buy the largest volume possible and to offer targeted discounts. All these considerations led the Tribunal to recommend conditioning the merger so as to avoid anti-competitive effects related to the portfolio created by the transaction.

The **Chairman** commented that one of the things the Spanish delegate had stated was that even if the market had been defined differently, the potential anti-competitive impact of portfolio effects would still have been considered. That contrasted with the Hungarian contribution's statements that:

- ... the Office of Economic Competition (OEC) has considered the conception of "portfolio effects" only a few times. The reason for this moderate attitude is the fact that the OEC has tended to adopt a relatively broad market definition.

This led the Chairman to again pose the question, why would there be a difference in concerns about portfolio effects depending on the market definition? He also expressed interest in the *Prodax/Schneider Electric/Prodax* transaction, a conglomerate merger apparently involving portfolio effects. The Chairman requested a description of that case and its outcome.

An **Hungarian** delegate stated that the OEC does not consider its product market definitions to be extremely broad. Product markets are defined through the standard analysis of supply and demand substitutability. Complementary products are therefore never considered as substitutes. However, it is true that in recent cases the product markets were not narrowed down to special brands. This means the OEC examines possible post-merger exclusionary practices as potential abuses of a dominant position on a relatively broad product market.

Since January 2001, the OEC has considered portfolio effects in three cases one of which was *Schneider Electric/Prodax*. This merger, involving Schneider Electric acquiring 100 per cent of Prodax, differed from the Schneider merger that took place in France, because in Hungary on both relevant markets there was a great deal of competition. Schneider and Prodax were respectively active on the Hungarian industrial and retail electric appliances markets. The OEC considered that these two markets did not involve substitute products. Instead, they were complementary. Therefore concentration levels did not rise. Despite that, the OEC examined the possibility of increased market power stemming from portfolio effects. It found that as both undertakings, and therefore the post-merger entity, faced fierce competition on both complementary product markets, there was no reason to block the merger.

Another Hungarian delegate added a comment related to the Chairman's first question. Hungary uses the standard market definition methodology and tries to avoid including complementary products in the same market. Portfolio effects are strongly connected to products which are sometimes complementary, sometimes substitutes for each other, or maybe complementary for distributors but substitutes from the point of view of consumers. Adopting narrow market definitions, for example different brands, would yield many markets, dominant positions in each and mergers leaving market shares unchanged. This may be why some authorities

believe the portfolio effect concept is needed to get a fuller picture not so much of particular markets but of an industry as a whole. But the OEC takes a little broader picture on markets. So probably this is why the OEC does not need to use the portfolio effects concept, *i.e.* because it does not usually consider brands to constitute markets. With broader markets, mergers will more often lead to increased market shares. As those changes can be interpreted as a creation or strengthening of a dominant position, there is usually no need to bring in consideration of portfolio effects.

The next country the **Chairman** called upon was Switzerland whose contribution was devoted to discussing the *Unilever/Bestfoods* merger. It noted that in the agro-foods industry there may be well known brands which can nevertheless be easily displaced. In such a case, the portfolio effect of acquiring many different brands may not be so important. The Swiss contribution also introduced the importance of buyer power. The Chairman requested more information about *Unilever/Bestfoods*.

A **Swiss** delegate began by saying that in reviewing mergers, the Swiss competition authorities have only had one case involving portfolio effects, *i.e.* the Unilever (UL)/Bestfoods (BL) merger. It is notable that these two enterprises were simultaneously active on similar agro-food markets, as well as in different markets such as those for cleaning products. This was not a strict case of a conglomerate merger in the sense of their being no market overlaps. Nevertheless, given the fact that in Switzerland UL and BF operated for the most part in different markets, the portfolio effect theory was applied in the preliminary analysis of the merger.

The principal potential problems that the Swiss competition authorities considered were frequently cited in the various contributions to this roundtable (the one from Spain for example). They are referred to as well in an article by Alberto Heimler. The latter identified two principal risks: the risk of tied selling, and new flexibility enjoyed by the merged entity in terms of marketing, setting prices, etc., which could create high barriers to entry, and the possible exclusion of rivals.

The concerns then were of two types. First, the effects on retail markets (*i.e.* on product buyers); and second, effects on competitors.

Analysis of the UL/BF situation showed that the risks associated with portfolio effects were limited for three reasons:

- Swiss distributors have considerable negotiating power. Coop and Migros are the principal Swiss distributors. Coop sells many products and brands, but also produces its own brands. As for Migros, the majority of its goods are self-produced and sold under its own brands.
- Present and potential competition from other producers, such as Nestlé, is very strong.

- In addition, even if UL and BF benefit from certain strong brands on certain markets, the power of a leading brand was found to be relatively weak since it could be rapidly eroded or even replaced by a private brand.

The competition authorities did not find in this case a portfolio related Cournot effect (*i.e.* leading to the exit of rivals), an effect well explained in the Canadian contribution. Risks of eliminating potential rivals, as mentioned in the German contribution, were also not found.

The preliminary examination in UL/BF led to the conclusion that the merger did not lead to a competition reducing creation or strengthening of a dominant position. Consequently the merger was authorised at that stage, *i.e.* a deeper examination was not initiated.

4. Pro-competitive and efficiency enhancing effects of portfolio effects

The **Chairman** believed that this next subject constituted the core of the topic. Portfolio effects may have both pro- and anti-competitive effects and competition authorities must make a distinction between the two. In addition, some of the portfolio effects may be efficiency enhancing and others may be both anti-competitive and not so efficiency enhancing and again there is a difficulty in trying to identify which category a merger falls in. He noted that a number of written contributions talked about the pro- and anti-competitive, or the pro-efficiency and efficiency reducing impacts of portfolio effects in conglomerate mergers. He cited the Australian contribution, for example, as stating: "In some instances, mergers involving portfolio effects do not generate anti-competitive concerns and in some instances they are pro-competitive." The Chairman noted that the Australian contribution focused on two mergers: *Coca Cola/Cadbury Schweppes*, and *Guinness/Grand Metropolitan*. The former was prohibited on the basis of adverse portfolio effects, but the latter was permitted by the ACCC. Concerning *Guinness/Grand Metropolitan*, the ACCC states:

- ... the spirit industry was highly brand oriented and products tended to be marketed as individual brands rather than (under) the brand name of the supplier. Further, each brand tends to be specific to a particular category, and brand extensions do not usually cross spirit categories.

The Chairman was left wondering whether this also applied to the carbonated soft drink industry. He asked the ACCC to comment on the difference between the two cases, and to discuss how one can distinguish between mergers creating or not creating competition problems.

An **Australian** delegate said that the short answer to the first question was that in *Coca Cola/Cadbury Schweppes*, there were extremely high market shares after the proposed merger, but this was not so in the other case.

Concerning the Chairman's comment that the efficiency benefits of conglomerate mergers can in some countries be taken into consideration in evaluating them. Australia considers that some efficiency benefits from a merger may have a positive effect on competition and therefore can be taken into account in the competition analysis. The circumstances under which that is possible are spelled out in Australia's merger guidelines, as they are as well in US merger guidelines. While there are certain instances where a merger will give rise to an efficiency gain likely to translate into increased competition, there are also cases where efficiencies do not have that result. For example, a merger might create a monopoly and its potential cost savings would not necessarily likely be passed on in lower prices to consumers. A merger of the latter type would only be possible in Australia if the parties decided to follow the special process of seeking authorisation of the merger on the ground that the efficiency benefits exceeded any harmful effect on competition. They would have a pretty difficult time getting authorisation on that particular fact scenario, but it is not ruled out.

As for *Guinness/Metropolitan*, it has already been noted that the spirit industry was highly brand oriented, *i.e.* products were marketed as individual brands rather than under the brand name of the supplier. In contrast, the Schweppes name for example is applied across a wide range of products and has some value and appeal to consumers. In addition in spirits, Australian market shares were generally low. This was certainly the case in Scotch, Australia's largest selling spirit. In that market, the effect on concentration was minimal. It was only in vodka and gin that market shares were of any great interest.

In *Coca Cola/Cadbury Schweppes*, the merger had several dimensions but did not involve Coke wanting to acquire well known Schweppes international brand mixers, and Coke did not have strong brands in this area. Coke was the major soft drink company and had more than 60 per cent of the market. The next biggest competitor, in fact the only really serious competitor, was Cadbury Schweppes which had competing brands in the cola market and in the fruit flavour segments, plus some complementary brands in the mixer segment. Cadbury Schweppes had about 15 per cent of the soft drink market. The merger was opposed because it was thought it would substantially lessen competition in the market for the production and wholesale supply of carbonated soft drinks. Cadbury Schweppes had been a vigorous competitor to Coca Cola, and there was concern that the combination of the Coca Cola brands with international Cadbury Schweppes brands and some of the local brands would enable Coke to effectively control the Australian soft drink market. The combination would likely have limited the ability of the remaining significant competitor, Pepsi which only had an eight per cent share, to achieve effective distribution to non-super market outlets. A great deal of time was spent analysing the distribution markets and the way in which buying decisions were made in that market. Coke put up a couple of revised proposals

but under all of them they would still have acquired Cadbury Schweppes' major international brands. What would have been left was Coke with its 60 per cent market share plus all the big Schweppes brands and another competitor having merely regional, low strength brands which were hardly distributed outside of the supermarket channel.

One might ask whether it was the exclusive dealing arrangements with Coke that were the concern, and if they had been removed would that have done the trick? The Australian delegate said No. Removal of exclusivity in distribution would have been insufficient because it would not have addressed the market dominance which emerged. The delegate added that subsequent to this merger being rejected or opposed, a better market outcome emerged that was not engineered by the ACCC. Pepsi and Cadbury Schweppes got together and this appears to have strengthened competition in this market.

The **Chairman** next noted that the German contribution states that there are different views on the consequences for competition of product range extension. It acknowledges that in some cases there may be pro-competitive effects, but the contribution gives the impression that this is considered to be the exception in Germany rather than the rule. The contribution also states that there may be efficiency enhancing properties of conglomerate mergers with portfolio effects, but notes that the Bundeskartellamt (BKA) generally does not examine the question of efficiency under merger control. What is left appears to be mostly the negative side of portfolio effects. This was illustrated in the *Henkel/Luhns* case in which two firms planned to establish a joint venture to pool their European retail brand businesses in detergents and cleaning agents. The contribution tells us that the Bundeskartellamt prohibited the merger because:

- ... it would have further consolidated Henkel's existing position of dominance on the general detergent market. This consolidation was attributed both to the small increase in market share and to considerable synergetic effects and economies of scale in production, procurement, and turnover... However, the most significant consolidatory effect of the concentration lay in the massive extension of Henkel's scope of action *vis-à-vis* its rivals and the retailers on the opposite side of the market.

So the case featured a strong initial market position (*i.e.* Henkel), a portfolio effect, pro and anti- competitive effects, and efficiencies. The Chairman asked what would have happened in this case if the BKA had been able to factor in the efficiency benefits.

Before addressing the Chairman's question, a **German** delegate briefly referred to parts of the German Act against Restraints of Competition (ARC) before its amendment in 1992. The pre-1992 ARC contained a special regulation which applied, *inter alia*, to assessing conglomerate mergers. The Act presumed market

dominance in mergers of undertakings with a combined annual turnover of at least 12 billion Marks, provided that at least two of the participating parties reached turnovers of at least one billion Marks. This provision was based on the experience that at least in partial areas in which the firms were active, a paramount market position may be created or strengthened solely as a result of the accumulation of resources. The clear aim of this provision was to facilitate proving a dominant position in conglomerate mergers. The provision was abandoned in 1999 because it was regularly disproved in practice and had not gained any practical significance.

Turning to *Henkel/Luhns*, the delegate noted that Henkel is one of Germany's leading chemical firms and sells a large number of well known branded detergents and cleaning sector products ("Persil" for example). Luhns is active in the same markets. The plan was to establish a joint venture to pool their European retail detergents and cleaning products businesses. The BKA determined that Henkel had a dominant position. Extensive market surveys carried out by the relevant Decision Division and investigations by market research institutes estimated market shares between 40 and 50 per cent.

According to German competition law, the creation or strengthening of a dominant market position is the only criterion to be taken into account in assessing a merger. An undertaking is considered to be dominant, *inter alia*, if it has a paramount market position in relation to its competitors. Whether a paramount market position exists is evaluated on the basis of an overall appraisal of all the relevant circumstances of an individual case. The Act specifies a number of criteria: market share, financial power, access to supply and sales markets, links with other undertakings, barriers to market entry, actual and potential competition, the ability to switch to other goods or commercial services and the ability of the opposite side of the market to resort to other undertakings. This list is not exhaustive. Positive efficiency gains resulting from a merger are not taken directly into account. They are only included in the appraisal if they have effects on the creation or strengthening of a dominant market position.

In addition, the BKA analyses a merger with regard to the so-called balancing clause. That means a merger can be cleared despite the creation or strengthening of a dominant position if it will lead to improvements in competition in other markets and these improvements will outweigh the disadvantages of dominance. However, this consideration again is an assessment of the conditions of competition in various markets. Efficiency gains again can only be taken into account with regard to their significance for competition.

The last and only possibility to clear a merger on the basis of criteria that are not part of the assessment of market dominance is the ministerial authorisation. A merger prohibited by the BKA may be cleared by means of a ministerial

authorisation if the relevant restraint of competition is offset by the overall economic advantages of a merger. However, this instrument has been very rarely used.

In *Henkel/Luhns* the BKA concluded that the cost and innovation advantages which would have been created by the merger contributed solely to further strengthening Henkel's dominant position. Furthermore since no positive effects on competition were found to exist in other markets, the aforementioned balancing clause was not employed. As a result, the BKA blocked the joint venture.

The **Chairman** next turned to the Netherlands noting that at paragraph 10 of their submission it is stated that: "Although most research on the effect of multi-market contacts indicates that it increases the feasibility and sustainability of collusive behaviour, it is not unlikely that conditions exist under which a conglomerate merger may actually increase competition incentives..." In addition, the contribution states that conglomerate mergers can generate static and dynamic efficiencies which, as in Germany, cannot be directly considered. The contribution also discusses the *Wegener Arcade-VNU Dagbladen* merger which arose in the advertising media sector. The Chairman found this case particularly interesting because the contribution states that it involved portfolio effects expected to produce better services for customers, an effect that could not apparently be treated as a positive effect in assessing the merger. The Chairman asked the Netherlands to present to its views with respect to taking account of efficiency gains linked to portfolio effects, and to provide details concerning *Wegener Arcade-VNU Dagbladen*.

A delegate from the **Netherlands** began by saying something about the definition of conglomerate mergers as described in the Secretariat's background paper, *i.e.* conglomerate mergers are considered to be those where parties are neither actual nor potential competitors, nor involved in a customer-supplier relationship. That paper also said that portfolio effects involved combining branded products in which parties have some market power that are sold in neighbouring or related markets.

The delegate remarked that much of the discussion to this point had focused on joining different products in one geographical market. The Netherlands believed that the definition should be expanded. One should not only look at joining different products in one geographical market but also consider identical products in different geographical markets. A possible example would be mobile telephone markets where big international companies buy identical franchises in different countries, even though they are not actual or potential competitors in those markets, for example because of the auctioning system. One could also think about airlines, or cable TV or electricity distribution. There is no overlap but the products are to some extent complementary because, for example, there is a subscription to a mobile telephone company that offers services in different

countries. The delegate remarked that this is very much related to the literature on multi-market contact, which has mostly focused on over-lapping product markets and related geographical markets. This literature shows that companies meeting in multiple markets tend to charge higher prices than companies that do not meet in multiple markets. The Netherlands believes it would be interesting to see if similar effects exist in the case of companies offering multiple products in identical geographical markets. There seems to be no empirical literature on the effects of this kind of multi-market contact.

Considering the Chairman's question about increasing competitive incentives, it has been noted that uniting multiple products within one company could actually create some kind of home advantage thereby, for example, making collusive behaviour more sustainable. However, the Netherlands considers it very likely that the opposite may result. It is a very difficult question to decide *ex ante* what the effects of conglomerate mergers will be.

The *Wegner Arcade-VNU Dagbladen* case involved two newspapers and free door to door weekly paper publishers. In this case the Netherlands treated the portfolio enlarging effect of the transaction as an additional effect on top of the dominant position issue. The acquiring company already owned one of the two national distribution networks for newspapers and door to door papers. Its competitors did not own such a distribution network and would become more dependant on the post-merger entity. They would be left with just one distribution option even though nothing changed in terms of market power in this distribution network. Substitutability between advertisements in local free papers and daily regional newspapers was also considered in this case as was the bundling of such advertisements, considered to be imperfect substitutes, in free weekly newspapers and subscription daily newspapers. This could create advantages that could not be matched by the other publishers that only disposed of one or two regional newspapers or free door to door papers. So there was concern that bundling might prevent entry into the lower price/quality segment of the advertisement market, *i.e.* the free paper market, and therefore in the long run also to entry into the higher price quality segment, *i.e.* the daily newspaper market. However, in the end, portfolio effects were not decisive. It was the creation or the strengthening of the dominant position which was central here and the portfolio effect was a supporting element.

Summing up, the delegate noted that while the Netherlands believes that portfolio effects are important, it has yet to have a case where on their own they have led to a negative decision. The Netherlands also believes that multi-market contact, especially as regards multiple geographical markets, should be considered in addition to multiple product markets in one geographical market.

The **Chairman** registered a possible desire to return in the discussion to the fact that the barrier to entry effect was a consequence of advertisers really liking the bundle that would have been offered by the merging firm. *Wegner Arcade-VNU Dagbladen* seemed to be a case where it was very hard to distinguish between the efficiency effect and possible anti-competitive effects of the practice. That led the Chairman to the Irish contribution where the same issue is also discussed. He stated that this contribution makes two points: first, that market power has to exist before one should worry about portfolio effects because they are very unlikely to develop unless one of the merging firms has a very strong market position; and second, bundling may have efficiency enhancing as well as anti-competitive effects. The Chairman was eager to learn more about how one can distinguish between the two effects and how they can be balanced against one another.

An **Irish** delegate drew attention to two types of mergers. He turned first to mergers involving complementary products. He considered these to be very much like vertical mergers for which there is already a good analytical framework available. Such mergers are presumptively efficient and feature strategic fits, economies of scope, and benefits from internalising externalities or providing one stop shopping. There can also be exclusionary effects from mergers involving complements, particularly if by restricting competition in one market, one is able to prevent it in another as well. There are a variety of theories about that. Whinston provides one. Another concerns preventing toe-hold entry into a primary market. These arguments are much more familiar to competition officials in the vertical context. If a competitor manages to get control of the distribution network, it can perhaps limit competition at the manufacturing level. The delegate was sceptical about the idea of introducing a doctrine of portfolio effects when the issues can be just as well be addressed within existing frameworks through analogy to vertical measures.

The delegate went on to stress the importance of realising that rival behaviour it is not exogenous. Rivals do not simply decide whether or not to enter or stay in a market. They have a range of choices that includes becoming more efficient in response to a merger that increases a rival's efficiency. This is a point that must be remembered in vertical mergers generally.

The delegate argued that, as with their vertical analogue, mergers involving portfolio effects and complementary products should be presumed efficient unless one can see a clear exclusionary effect. Things become different, however, if there is an element of substitutability involved. In the past, the Irish Authority very clearly stated that scotch whisky and other spirits exerted no competitive influence over Irish whiskey. The Authority was probably not alone in opting for such narrow market definition. It did this because it raised market shares to 75-95 per cent. As a consequence of its dominance test and other factors, the Authority has adopted very narrow market definitions to get market shares up to

comfortably high levels to deal with Article 81 and 82 cases and sometimes mergers. Narrow market definitions which are inculpatory in Article 82 cases become exculpatory in mergers because they reduce the incidence of market overlaps. Perhaps competition officials are seeking to avoid the effects of earlier overly narrow market definitions by introducing the portfolio effects concept, *i.e.* they are applying portfolio effects to mergers involving products that are more substitutes than complements.

The delegate's third point dealt with how the substantial lessening of competition (SLC) test might assist competition officials in dealing with problems explored in this roundtable. He believed there were three reasons for expecting it would. One is that an SLC test facilitates distinguishing between the vertical and horizontal analogy or between complements and substitutes. The dominance test rather simplistically focuses on market shares. Secondly, the SLC test enables measuring market power directly, reducing over-concentration on structural factors. And thirdly, one of the underlying concerns in this area is that efficient mergers usually will result in increases in market share in either the short or long run. That could be counter-balanced by reactions by competitors. Ironically, if there is such a helpful reaction, there is probably no increase in dominance.

In jurisdictions employing a dominance test, one should avoid blocking mergers which create efficiencies and simultaneously raise market shares. In the long run, the pressure generated by such mergers will drive rivals to become more effective competitors.

The delegate summed up by saying that the vertical/horizontal merger distinction is very useful, and that competition officials must move away from the constraint of very narrow market definitions. He also urged caution in the application of exclusionary theories in merger review.

At this point the **Chairman** returned to the United Kingdom this time focusing on the difference between natural and strategic advantages possibly conferred by conglomerate mergers involving portfolio effects. The natural advantages refer to things such as economies of scope, scale and density which may have both anti-competitive and efficiency enhancing characteristics. He again asked: "How can we empirically distinguish between those effects and weigh them against each other?"

A **United Kingdom** delegate confirmed that "natural advantages" is a kind of short hand description for all those things that lead to a merger offering customers a better deal. Such a development might also deter entry, but in the case of merger induced efficiencies it will be the inefficient which do not enter, which is exactly as it should be. With natural advantages the interests of customers and the merging parties coincide. They may be against the interests of the less efficient or now less efficient competitors, but that is just the way competition works. In

contrast, the so-called strategic advantages refer to the greater capacity for anti-competitive behaviour, such as raising rivals' costs, which is generally more of a worry in vertical settings than in purely horizontal or conglomerate settings. There are also the well-known issues of bundling and tying.

As to the balancing of anti-competitive effects and efficiencies, the first question to ask is whether there is a well established, coherent theoretical possibility of anti-competitive behaviour, *i.e.* something which harms consumers as well as rivals. Is that coherent theoretical possibility realistic on the facts of the case? If it is, then a second issue is raised, namely whether that risk could be contained equally well and equally efficiently *ex post* by the general application of competition law. There are often quite substantial difficulties in treating the same issues efficiently *ex post*. There can sometimes be problems, for example, in applying behavioural remedies to merger situations.

While the above questions must be asked there may also quite often be "plain vanilla" loss of horizontal competition issues that need addressing, such as those the Irish delegate touched on. In a sense these issues help keep one honest doing market definition.

Where a balancing is required, *i.e.* there is a serious possibility of an SLC, the OFT would generally advise referring the matters to a second stage investigation. At that stage one would determine whether despite the SLC, the merger was pro-consumer because of more than countervailing efficiency benefits flowing through to customers in the market in question. There are likely to be relatively few such cases.

The **Chairman** then turned to the last contribution, that of the United States Department of Justice (USDOJ), saying it addressed three related theories of competitive harm: first, the mergers will create economies of scale and scope that other firms will not be able to match; second, the merged firm will gain a decisive advantage over its competitors; and third, the merger will facilitate the tying or bundling of complementary products. In the view of the USDOJ, the first two effects are not really problematic because they are efficiency enhancing. As for the third effect, the submission states: "Most stories of tying and bundling are not foreclosure-motivated, and only some of them are even foreclosure-related, and even the foreclosure-related tying/bundling stories have ambiguous welfare effects."

Focusing on the third effect, the Chairman wanted to know how the USDOJ would have handled a hypothetical merger between a major computer firm with a very large market share in operating systems and another firm strong in browsers. Would there be no competitive problem in such a merger?

The Chairman also noted that the USDOJ contribution expressed concerns about the practice of other jurisdictions and wondered whether application of the

range effects theories will lead anti-trust regulators to disapprove efficiency-enhancing mergers on the basis of highly speculative and unprovable theories of competitive harms. It also makes the point that without a high standard of proof, range effects theory runs the risk of becoming an ill-defined, catch-all theory that allows anti-trust regulators to challenge virtually any merger on the basis of vague fears of dominance. The Chairman asked whether the discussion at the roundtable had alleviated some of the USDOJ's concerns about how other jurisdictions are applying the portfolio effects concept.

A delegate from the **United States Department of Justice (USDOJ)** noted that given the reaction to some of his remarks made earlier in the week, he wished to begin with a brief preface.

The delegate stated that the USDOJ very much welcomed the opportunity to engage in a public debate as well as private discussion over the range effects doctrine and its application to particular cases because of its belief that it raises an issue of fundamental importance to competition policy. The USDOJ has engaged in such a debate in the US over the last four years with respect to the theories advanced in the *Microsoft* case to which the Chairman alluded. That debate served importantly to help refine the issues, sharpen the dispute and to inform the Court of Appeal's excellent decision in that case.

The delegate said that the USDOJ paper seeks to explain the reasons for the USDOJ's decision not to challenge *GE/Honeywell* on a range effects theory. The USDOJ felt it owed the global antitrust community a reasoned explanation for its decision especially since antitrust decisions are always so fact specific.

The delegate stated that competition authorities share a common mission – to stop mergers that are anti-competitive and thereby harm consumer welfare. Sorting out good from bad mergers is difficult enough, even in the case of pure horizontal mergers. It is even more difficult in the case of vertical and potential competition mergers. When we move to mergers of complements we enter an area of much greater uncertainty. Some of those mergers can be characterised as vertical mergers, as the Irish delegate mentioned, but the US delegate did not think that *GE/Honeywell* involved vertical relationships as such, except perhaps for the GECAS issue. Especially when a theory of competitive harm proceeds from the premise that the merger will initially lead to lower prices and better products and that competitive harm will occur only if and when competitors are forced to exit the market, one is necessarily trading off short term benefits against speculative long term harm. In such cases there is a risk that competition authorities will get the trade-off wrong. The delegate believed that a century of anti-trust enforcement has taught competition officials that predicting long term effects of mergers is hazardous at best, especially when discounting for time and uncertainty.

In response to the Chairman's question, the delegate said he was very reassured by the discussion at the roundtable. When parties raise portfolio or range effects with the USDOJ, such concerns are investigated, but in virtually every case they are found to be exaggerated and do not support a challenge. The delegate felt this was the conclusion most of the competition officials around the table also reached when they examined portfolio effects. The USDOJ bottom line is that before a case is brought on this kind of foreclosure theory, it has to be built on solid economic theory and a strong empirical basis. He then went on to comment on the EC delegate's remarks on leverage and foreclosure.

The delegate stated that the USDOJ would certainly agree that there are circumstances in which forced tying by a firm with market power in the tying product would be anti-competitive and therefore unlawful. The action against Microsoft was just such a case and the USDOJ is pleased with its victory there, but it is important to note that the Court of Appeals focused not on the fact of the bundling but on the way in which it was done and the lack of business justification for it.

With respect to the Chairman's question as to whether the USDOJ would challenge a proposed merger between Microsoft and Netscape in 1996, the delegate reiterated that merger investigation is very fact specific. The USDOJ would have examined horizontal and potential competition issues in that case. Its problem with the range effects decisions it has seen is that they appear to extend well beyond forced tying of the type that would be unlawful under US antitrust laws.

It is not unlawful for example for a company to physically integrate two complementary products while continuing to sell the components separately. If it were, Kellogg's' introduction of frosted flakes would have been unlawful. Nor is it unlawful for a company to offer a bundle of products at a lower price than it charges for individual components so long as the price is not predatory. With respect to that, the delegate took a moment to address what he considered to be a false distinction between strategic pricing and real economies of scale and scope, *i.e.* cost savings. In cases dealing with predatory pricing, US courts have squarely held that even where a monopolist lowers its price for strategic purposes, for example to deter entry, that is not unlawful unless the resulting price is below cost. And finally, it is certainly not unlawful for a company to discount the prices of its products because it recognises that offering a lower price for one product will increase sales of other complementary products. If it were, Gillette would have to charge a much higher price for razors. In all of these cases, the customer remains free to choose between buying the bundle or buying the components individually. Consumer choice is maintained. The only way in which there is potential consumer harm is if rivals are foreclosed from the market, *i.e.* they are driven from the market. The problem there, however, is that the competitive process is all about encouraging the most efficient to grow at the

expense of the less efficient as several of the other delegates have already said. Competition enhances consumer welfare because it rewards success and punishes failure.

With respect to *ex ante* versus *ex post* remedies, the only thing the delegate wished to add is that the discussion is not focused on the importance of deterrence. Where one has substantial fines or treble damages as the US does for anti-competitive behaviour, so long as those sanctions are imposed with certainty, severity and celerity they can be an effective deterrent. The delegate briefly noted that the USDOJ "Remarks..." document (see the room document accompanying the US submission) contains some suggestions for future work.

The US intervention was continued by a delegate from the **United States Federal Trade Commission (USFTC)** addressing the Chairman's question about balancing. He began by noting that merger review is essentially an exercise in predicting future effects and proposed four operational steps to assist in that.

The first step is to focus on short and medium term effects by enquiring into whether there is substantial market power and plausible efficiency claims affecting price and quality. Step two is to peer into the future to look at long term effects through addressing four questions:

1. How will rivals respond?
 - Answering this question implicitly involves a judgement about the adaptability and resiliency of the market process.
2. How will purchasers respond, *i.e.* do purchasers have the capacity to adopt counter-measures to possible price raising or quality suppressing strategies?
 - This again requires making a basic decision about the adaptability of purchasers. The reviewer is working with a dynamic model requiring assumptions about the strategic interaction of all the players.
3. Will there be new entry either through *de novo* entry or the repositioning of other firms into the product market.
4. How adequate are *ex post* competition policy remedial solutions to restrictive practices or abuse of dominance?
 - The answer to this could be different across countries.

Addressing the above questions leads to the third step in the process. If one finds short term benefits to be plausible and significant, and if one has faith in the efficacy of the long term competitor and customer responses, one will emphasise the short term benefits and discount the potential long term harms. If one makes the contrary assumption, a different policy outcome will follow.

As the fourth operational step, the delegate proposed that assumptions about market adaptability be tested by competition authorities routinely conducting *ex post* assessments of the effects of their activities. He recognised that there was some hesitation to do *ex post* inquiries. Such assessments can lead to concluding that: one improved the situation; one had no effect at all; or one made things worse. Two of those three would be unwelcome results. The delegate nevertheless believed that *ex post* assessment was a necessary final element of the merger review empirical process. Empirical testing of actual outcomes provides a way to determine whether or not the assumptions one makes in the earlier elements of the inquiry require adjustment or should be left as they are.

After endorsing the last delegate's call for *ex post* review of merger decisions, and recalling that he has often advocated such a practice, the Chairman opened the general discussion by calling on the Business and Industry Advisory Committee delegation (BIAC).

A BIAC delegate began by noting that when the 1992 USDOJ and USFTC guidelines set forth market and firm conditions under which application of co-ordinated interaction and unilateral effects are appropriate in assessing the likely effects of a merger, it was recognised that even those standards were not themselves always amenable to quite certain, clear conclusions. The notion of undertaking an *ex post* analysis of whether the decisions were right or wrong would therefore be most welcome. To the extent that the application of a portfolio or range analysis adds a third element of anti-competitive effects, there is obviously an increase in complexity and uncertainty in merger enforcement although the agencies are attempting to clarify the conditions where anti-competitive portfolio effects are likely to occur. These conditions embody a somewhat more speculative framework than those applicable to other theories. Portfolio effects arise from the merger of complements or products that have a high positive correlation in value to consumers. With few exceptions, mergers of this kind should raise no anti-competitive concerns.

The Secretariat's background paper lists seven elements that signify the likelihood of adverse portfolio effects. According to that paper, a tying theory would require two elements: market power in the tying product; and a large number of buyers desiring to purchase only the tied product. These are structural elements that merger enforcers/officials can readily determine. The remaining elements in the paper require insight into future actions and market reactions which would seem difficult at best to predict *a priori*. First, rivals' costs must increase and the rivals must not be able to similarly engage in tying, bundling or other non-linear price strategies to offset the market advantage of the merged firms. Second, rivals' inability to effectively respond would then cause prices to rise or erect barriers to entry. Third, supra-competitive prices would enable the merged firm to recoup any losses in executing the exclusionary strategy to drive rivals from the market.

Last, buyers would suffer a net welfare loss over time from such exclusionary behaviour. Courts and enforcement agencies are familiar with identifying and assessing the risk of exclusionary behaviour leading to complete or partial market foreclosure.

Determining whether one or more of the mentioned elements or conditions are present and would lead to anti-competitive portfolio effects requires knowledge of the economic incentives of the merged firm. Knowledge of the cost structure of the merged firm and its rivals and a relatively sophisticated knowledge of the reaction functions of market participants are needed to truly assess the likelihood of anti-competitive exclusionary conduct emerging from a merger of complements. The ease of doing this may have been underestimated. Even supporters of the portfolio theory of anti-competitive effects, for example Balto/Tom and others, have identified a number of limiting principles that are necessary for the efficacy of this theory. The delegate called on one of his colleagues to continue on that point.

The second delegate stated that there is an urgent and pressing need for continuing debate and early resolution and guidance from competition law enforcement authorities regarding the specific situations in which a conglomerate merger involving products sold to the same customer may be challenged under the portfolio or range theory. The current fundamental differences in views creates great uncertainty in the international business community, chills merger planning and undermines respect for law enforcement in the merger domain.

Pending some resolution of differences, BIAC urges that the portfolio effects theory be applied narrowly and cautiously. This is warranted given the immediate benefits that may arise to consumers from a price reduction and/or better integrated product offerings as opposed to the more speculative possibility of longer term harmful effects. BIAC further suggests that when enforcement authorities have other remedies available, *i.e.* prohibitions of restrictive practices or abuse of dominance, these should be depended on in preference to blocking mergers.

The delegate's final point concerned the portfolio effect theory's scope in relation to low pricing. One particular concern is that the theory assumes that the merged identity will be able to bundle several products and sell the bundle at a lower aggregate price than can be offered by competing suppliers. However, there does not appear to be any specific requirement that the bundle price be below a particular measure of cost. The question being asked, and one that BIAC hopes enforcement authorities will try to address, is whether one is talking about average total cost, average variable cost or marginal cost, or some other measure? And this is but one illustration of the difficulty that those planning mergers are facing at this stage given the fundamental differences that exist. In sum, BIAC urged enforcement authorities to be very cautious about challenging mergers

based on portfolio effects in cases where a transaction is likely to generate immediate consumer benefits on the one hand and only speculative long term anti-competitive effects on the other, especially when a reviewing authority has recourse to other conduct directed remedies.

A **Mexican** delegate referred to his country's experience with the portfolio effects theory. He recalled three cases where portfolio effects had been a significant element in merger review, and noted that many of the issues discussed in the roundtable surfaced in those deliberations. The first was *Coca Cola/Cadbury Schweppes*. Although this merger was blocked, portfolio effects were not the reason for that even though the market share of Coca Cola in Mexico is probably larger than even in Australia and it was expected that increases in market share stemming from the merger would substantially increase the market power of Coca Cola. The rejection stemmed from the fact that Coca Cola did not address the problems raised precisely by portfolio effects in inter-related markets. Coca Cola had a record of engaging in very significant exclusionary behaviour through its agreements with different distributors across the country.

The second case was the merger between *Televisa* and a radio operator. Televisa had a very strong dominant position in the TV market and a significant position in the radio market, and the merger made post merger bundling very likely. Again past experience was examined and showed that Televisa had made extensive use of bundling and had engaged in exclusionary behaviour. Once more, this was a very important consideration in the merger review, especially when it was noted that other jurisdictions restrict cross-ownership of TV and radio situations.

The third case concerned Mexico's sole oil producer and gasoline distributor, Pemex, which entered into an exclusive agreement for the sale of lubricants in its gas stations. That agreement was prohibited because it implied complete foreclosure of competing lubricant producers in the gas stations.

The delegate felt comfortable with the three decisions described, and found himself in agreement with much of what he had heard in the roundtable. He endorsed caution in applying the portfolio effects theory. One must avoid speculation as to possible effects and try to find direct evidence on how foreclosure might occur and how tied selling would affect consumers. Efficiency aspects must also be considered. He also agreed with Ireland that a doctrine of portfolio effects is unneeded. Existing tools are adequate to deal with the issues.

A **French** delegate supplied a brief commentary on two *Coca Cola/Orangina* merger decisions. In 1999, there were two notifications, two decisions and two rejections based on the portfolio effect theory. Unknowingly, the French authorities followed rather closely the Secretariat's analytical framework. The delegate therefore considered that framework and its seven points quite pertinent.

The competition authorities distinguished between two different markets, *i.e.* on premise consumption; and sales through large scale distributors. The delegate supported what the UK delegate said previously. A problem was found in the “on premise” sector but not in large scale distribution. Indeed, in the latter sector, distributors had considerable countervailing power which offset market power linked to portfolio effects.

It is fundamentally important to note that the portfolio effects theory was not applied in a totally isolated fashion. That theory was employed in a concrete case where there were other serious competition issues linked to market power, including high shares in defined markets.

The application of portfolio effects in the two *Coca Cola/Orangina* decisions attracted a good deal of critical attention. The two decisions had a lot in common with decisions taken by other competition authorities. The French authorities indeed applied the market definitions adopted by the European Union as well as by the Mexican and Australian authorities. The delegate therefore believed that the various competition authorities were applying fundamentally the same analysis.

The delegate concluded by saying that he was very interested in the methodology proposed by the US and notably the idea of doing post-merger evaluations.

A **German** delegate returned to the Chairman's remark regarding efficiencies and a point made by Ireland concerning the difference between the SLC and dominance tests. This seemed particularly interesting because in *GE/Honeywell*, the European Commission applied the dominance test while the United States used the SLC test. Germany uses the dominance test but that does not mean that it is completely market share oriented. In addressing the question of whether or not there is a paramount market position, the BKA has the opportunity to make an overall appraisal concerning market shares, financial power, access to supplier and distribution markets, and so on. So, the dominance test is not as market share oriented as Ireland remarked. Even efficiencies can be taken into account within this test, but only as regards their relation to competition. Differences in US and EC decisions, as in *GE/Honeywell*, may be more the result of two different economic approaches than of two different tests. As the BKA's former President Mr. Karte used to say, merger law and security of law are hostile brothers.

An **Italian** delegate noted that a pure conglomerate merger should have no effect on consumer prices, hence on the consumer welfare that competition authorities seek to advance in their merger reviews. In a complementary products merger the transaction should reduce prices thereby benefiting consumers. So where does the worry come from? It comes, in the delegate's opinion, from the threat of foreclosure, *i.e.* that the merged firm will be able to use techniques such as targeted discounts to exclude competitors with the effect of eventually raising

prices. So there would be a short term benefit and a long term harm. Some cases, notably GE/*Honeywell*, are pure bundling cases. They also involve some demand effects having possible foreclosure impacts.

The delegate urged that a broader analysis be applied in order to recognise the complexities presented by some mergers because of the many inter-linkages, demand effects, etc. involved. For example, in the *Grand Met* case the problem might have been the possibility of target discounts being used post-merger. Guinness might have foreclosed rivals from competing and its targeted discounts could have resulted in below cost marginal prices. In that respect they could have threatened competition and indeed foreclosed rivals. Of course, competition officials have to assess whether such behaviour is probable and whether it will indeed have exclusionary effects.

A **Danish** delegate noted that portfolio effects are probably not the biggest problem competition authorities face given the continuing merger wave, especially since studies seem to show that conglomerate mergers are not an increasing proportion of mergers. Nevertheless, conglomerate mergers do occur from time to time and it is important to consider what to do with them. The delegate believed that nobody in the roundtable had really come up with good suggestions for balancing the pros and cons of such mergers. He had listened with interest to the US proposed classification, but found it paid insufficient account to the fact that some proposed remedies may have short term and others longer term effects. The US approach seemed better geared to simply saying yes or no to a merger. But if one is able to negotiate remedies, things are actually more subtle.

Denmark had a large bank merger that involved some portfolio effects. The partners in question had different banking, mortgage, insurance products, etc. The Competition Authority feared this portfolio merger would raise rivals' costs and therefore adopted a remedy to allay those fears.

Denmark believed there is really no need for a new doctrine on all this; present tools are adequate. The delegate agreed with Ireland and the United Kingdom that the dominance and SLC tests are more or less convergent and that differences should not be exaggerated. He nevertheless supported moving to the SLC test which seemed better able to cope with the issues the roundtable was focusing on.

A **European Commission** delegate underlined a point made by BIAC. He acknowledged differences existed between the EC and the US, but emphasised the need to resolve them. The EC is striving for more, not less convergence. The delegate also wanted to point out apparent agreement on two things. First, under more or less stringent conditions, a conglomerate merger can harm competition or lead to exclusionary effects just as the Italian delegate had noted. Second, delegates seem to agree that a conglomerate merger can give rise to various

efficiencies. The delegate questioned the requirements for accepting such efficiencies, noting that the EC believes that in close call situations the parties should be requested to demonstrate and prove efficiencies.

A **Hungarian** delegate questioned whether the SLC test would be better than the dominance test in the context of mergers having portfolio effects. He did not believe there was much difference between the two and that in any event market definition is critical for both. If markets are defined narrowly, for instance to the point of being individual brands, an SLC will rarely be found as a result of a merger. He also noted that it would probably be useful to distinguish between the validity of the portfolio effect doctrine and the wisdom of frequently using it.

A **United States Department of Justice** delegate noted that with respect to remedies, acceptance or prohibition are not the only *ex ante* options. Imposing conditions on a merger is also a possibility. That is what the USDOJ typically does in vertical merger cases thereby permitting parties to realise expected efficiencies while at the same time preventing them from engaging in anti-competitive exclusive dealing, tying, and refusals to supply. As to the EC delegate's point about efficiencies, the US requires parties to prove claimed efficiencies. He thought it very important that competition authorities clarify that they will integrate efficiencies into competitive effects analyses and view them as something positive rather than negative.

The **Chairman** closed the roundtable with some summary remarks based on personal impression. He began by noting what he thought was an absolute consensus in the views expressed, *i.e.* that portfolio effects in conglomerate mergers should be handled in a cautious way. He was also sensitive to the fact that there appears to be a fair amount of analytical convergence, and that statements to the effect that there is a very deep divide in the theoretical considerations going into those analyses did not seem to have been reflected in the discussion. There was no question of whether one wanted to protect competitors or competition. Everyone wanted to protect competition and efficiency. The possible problems or differences lay elsewhere, perhaps in the design of laws. It was argued that the choice of test, SLC *versus* dominance, could affect what one could look at or how much freedom one had in looking at certain things.

The Chairman believed, although some downplayed it, that there is possibly a significant difference between jurisdictions. Those using the SLC test may have greater flexibility in looking at the various anti-competitive effects of a merger. This may also affect how efficiencies are considered. There are two times in merger review when one can look at efficiencies. One can consider them when trying to determine whether a dominant position is created. At that point efficiencies may usually be found to reinforce the dominance of whoever benefits from the efficiencies. Efficiencies therefore end up on the negative side of the ledger,

not because efficiencies are negative *per se* but because efficiencies accruing to firms will make them more powerful or dominant. But there is a second way to look at efficiencies which is not when one defines dominance or considers possible anti-competitive effects, but rather when assessing the countervailing effects of efficiencies, *i.e.* as part of the redeeming value, so to speak, of the merger. In that case, the same efficiencies seem to be quite on the positive side.

The Chairman also drew attention to something not much developed in the discussion, *i.e.* the transformation of the notion of products or services. Bundles were discussed as being something different, something which themselves may be demanded. This led directly to a question from BIAC, namely once one goes from products to bundles, what is the concept of pricing that one uses to establish whether there is pricing having anti-competitive effects? Maybe competition authorities should be clearer about how they look at those pricing problems in the case of mergers having portfolio effects.

A conglomerate merger having portfolio effects may increase competition in some respects while decreasing it in others, and even if it decreases competition may have positive effects on efficiencies. The only difference the Chairman saw which makes the problem of conglomerate mergers even a bit more complicated than vertical restraints is that there can be delayed reactions in conglomerate mergers with portfolio effects. When competition authorities look at vertical restraints such as exclusive distribution or selective distribution contracts, it is usually kind of a static thing. All the effects appear at the same time. If there are delayed effects, for example, the prevention of entry in the future or the expulsion of a competitor, then one gets into what the USFTC delegate was asking about, namely how does one assess those delayed effects compared to the more predictable immediate effects?

The Chairman thought that all this fell within the realm of normal discussion of a complicated issue in competition policy and amounted to an attempt to devise an empirical test to sort the issues as clearly as possible. This was proposed by the EC and UK in their papers and by the USFTC delegate orally. The Chairman thought it was a very useful thing because competition officials concentrate their efforts on interpreting facts and it was there that the differences appeared rather than on the level of theory or the bare facts.

The Chairman's parting suggestion was that competition authorities try to keep refining empirical procedures, questions, and the order in which questions will be examined. This may bring sufficient clarity and transparency so that the business community will feel there is predictability in the process even in merger cases involving complicated issues.

Country Contributions

Further information from the following jurisdictions on the topic of Portfolio Effects in Conglomerate Mergers is available at: www.oecd.org/pdf/M00025000/M00025127.pdf under the topic “Best Practice Roundtables”.

Country contributions

Australia	Korea
Canada	Spain
Finland	Switzerland
Germany	The Netherlands
Hungary	United Kingdom
Ireland	United States, Department of Justice
Japan	European Commission

REFORM OF THE RAILWAY SECTOR IN RUSSIA

The rail industry in Russia is one of the largest in the world. Russia's vast distances, relatively under-developed road infrastructure, and high reliance on bulk commodities imply that the rail industry has a unique and key role in the transportation infrastructure of Russia. At present the industry is organised as a fully-integrated entity, operated by the Ministry of Railways. At a seminar in Moscow in December 2000, OECD experts and Russian officials discussed how this industry could be restructured to promote competition, enhance efficiency and to ensure that this industry best meets the needs of the growing Russian economy. The following summary sets out the key ideas and conclusions to emerge from that seminar. Three main topics are discussed: policies to establish a sound commercial environment for railway operators, structural options for competition and managing the transition to a competitive structure. A key issue is whether it would be possible to enhance competition by dividing the Russian rail industry into a number of vertically-integrated railways, competing for the provision of rail services along the key rail transport corridors.

Reform of the Railway Sector in Russia

*By Darryl Biggar**

1. Introduction

Reform of the rail sector is complicated by the fact that the same rail infrastructure is used to provide a wide range of transport services, of different products over different routes and distances – some of these transport services face intense competition from other modes, while others face very little competition; some rail services are highly profitable while other services must be subsidised. A successful reform must reflect these different circumstances in different markets.

In most western countries there has been a long-term decline in the share of rail in both freight and passenger traffic. This, combined with widespread state-ownership, a lack of commercial and entrepreneurial incentives, a lack of competition and a lack of flexibility in responding to the new market environment has lead, in the past, to low productivity and, in many cases, large losses. This combination of factors was, in the case of several OECD governments, the stimulus for major reforms of the rail sector.

The situation in Russia at present is somewhat different. The rail sector in Russia currently holds a special position in Russian transport markets. The market share of rail in both freight and passengers is much higher than OECD countries. Competition from road and air modes is not yet developed. The productivity of the Russian rail sector is low (around 5 times lower than in Canada, for example) which, in turn, is likely to harm Russia's economic integration, domestic growth and exports. It is timely to consider reforms of the Russian rail system before the rise of competition from other modes leads to greater financial pressure.

Rail reform involves attention to a number of distinct policies. These policies can be divided into three broad categories: establishing a sound commercial environment, promoting competition and managing the transition.

2. Establishing a sound commercial environment

As mentioned earlier, in many OECD countries the long-term decline of rail's market share was hastened by a lack of commercial incentives on railway enterprises which, in turn, limited the innovativeness and responsiveness of railway companies to customer demands. A substantial element of the reform, therefore, was simply giving the railway the freedom and the incentive to operate and compete like any other commercial enterprise. The key policies to be followed can be summarised:

- *Improved Accounting* – railway companies should prepare transparent and high-quality accounts to the best internationally-accepted accounting standards. (Developing accounts that separate financial flows between the infrastructure management and train operating parts of the business would be useful as would continued separation of freight and passenger operations, enabling both transfers between business units and the efficient use of resources in different parts of the business to be more clearly understood).
- *Removal of “Social Infrastructure” and non-core businesses* – “social support facilities”, such as schools and hospitals, and non-core activities, such as storage and insurance, should be separated out from the core commercial operations of the railroad.
- *Corporatisation* – railway companies should adopt the legal structure of a joint-stock company, able to raise funds on capital markets.

At the same time, it is important that railway companies face a “hard budget constraint” – in other words, that they do not have automatic and unrestricted recourse to state funds. This can be achieved by placing services on a sound commercial footing; allowing railway companies to withdraw from loss-making services and allocating any subsidies through an arms-length procedure.

Experience in some countries (especially North America) shows that even though some lines cannot be profitably operated by a large incumbent operator, in many cases service on those lines can be profitably provided by small railroads with different working methods. Rather than eliminating service entirely, it is desirable for small operators to be given a chance to operate those services which the incumbent wishes to give up as unprofitable.

- *Principle of commercial operations* – services should, as far as possible, be operated on a commercial basis. Railway companies should be free to withdraw from non-commercial operations, including withdrawing from loss-making lines.
- *Short-line railroads* – whenever an incumbent operator wishes to withdraw services on a line, the right to provide services on that line should be offered to other companies including shippers and small, new, entrepreneurial railroad companies.

In some circumstances, despite the principle that railway operations should be operated on a commercial basis, it is desirable to maintain certain loss-making services, such as commuter services into large cities. It is important that these services not be cross-subsidised from the internal funds of a railway company. There are two reasons why such internal cross-subsidies are undesirable. First, since the amount of such internal cross-subsidisation is not strictly linked to the costs of providing the non-commercial service, the railroad has weaker incentives for efficiency in the provision of the non-commercial services. Second, since maintaining monopoly profits is essential to the preservation of the cross-subsidy, the cross-subsidy will be used as an argument against the introduction of competition. It is sometimes said that “cross-subsidies are the enemy of competition because competition is the enemy of cross-subsidies”. Where subsidised services must be funded from within the railroad sector, the funds should be raised in a manner which is consistent with competition.

- *Handling of non-commercial services* – those non-commercial services that remain should be tendered. Where tendering is not possible, the amount of the subsidy should be determined through arms-length negotiations.
- *Handling of cross-subsidies* – subsidies should, as a first preference, be funded from general government revenues. Where this is not possible, subsidies should be financed in a manner which is consistent with competition, such as a tax or charge on all rail companies.

Many of these policies are already set out explicitly in the reform plans drawn up by the Ministry of Railways. We support those existing policies which are consistent with the above principles.

3. Promoting competition

As mentioned earlier, it is clear that in some markets, rail faces significant competition from other transport modes. In some countries this inter-modal competition is alone sufficient to discipline the market power of the rail sector.

In any case, it is important that these other modes compete with rail on a “level playing field”. For example, if the rail sector is responsible for the full costs of its infrastructure, so should other transport modes. In most countries, this means, amongst other things imposing special taxes on road users to pay for the road infrastructure, through taxes on petrol and vehicles. Sweden, rather than raise further the taxes on road users, has chosen to directly subsidise the rail infrastructure.

- *Attention to inter-modal competition* – competing transport modes should operate on the same commercial footing. If the rail sector must pay for the full costs of its infrastructure, so should other transport modes. All modes should pay the environmental costs that they impose.

For many Russian shippers (or travellers, in the case of passenger traffic) other transport modes are not a good substitute. These shippers face rail market power. As in other markets, that market power can be controlled either through price-regulation or some form of intra-modal competition (*i.e.*, competition within the rail sector).

It is our view that competition, wherever it is feasible, is strongly preferable to reliance on regulation. Competition stimulates forces of innovation and efficiency which tend to be dulled by regulation. One of the key questions addressed by the seminar, therefore, was the extent to which competition can operate within the rail sector.

The seminar highlighted two broad approaches to introducing competition in the rail sector, based on two different types of structural separation – horizontal and vertical.

The first approach involves a form of vertical separation – the track infrastructure is separated from the provision of train (or rolling stock) services. The train operating companies (or rolling-stock operating companies) compete with each other in the provision of transport services over the common track infrastructure.

The second approach involves horizontal separation, yielding competition between vertically integrated railway networks. These networks are designed in such a way that they compete with each other in offering services over key trade routes.

Each of these approaches has pros and cons. The best choice for any particular country will depend on a number of factors specific to each country, such as the geography of the network, the level of investment required and the relative importance of freight and passenger traffic. However, we may make a brief assessment of the merits of these two approaches in the Russian context.

3.1. Vertical Separation – Separation of track infrastructure and train operations

The first approach – the separation of the railway company into a track infrastructure company on the one hand, and train operating companies on the other (as in the UK) – has the primary advantage that it offers the potential for competition between rail transport companies in all places reached by the existing rail network. In theory, this is one promising approach for introducing competition within the rail sector, in both freight and passenger services.

The primary disadvantage of this approach is that separation of the track and train services introduces difficult contractual and regulatory issues. The contractual issues arise because the previously integrated operation of track and train services must be replaced by arms-length contracting arrangements. These contracts must specify the price and service quality desired and the actions to be

taken in the event of a number of possible contingencies, such as delays. The regulatory issues arise because, once separated, the track company is a natural monopoly which must be regulated. That regulation must ensure that the track company has incentives to expand the track, promote traffic growth, invest in and upgrade facilities, and do so in a manner which is as least disruptive as possible of existing traffic. The experience of the UK shows that maintaining all these incentives simultaneously on the track company is very difficult.

There are other problems that arise from a full separation of track and trains. If there is less than perfect competition in train services, the price for train services may be marked-up above marginal cost. This mark-up is on top of the track charges, which are themselves, likely to be above marginal cost. In effect, the shipper faces two successive monopolies in a vertical chain – which leads to a higher price than if these two monopolies were integrated. Another problem is that efficient charging for the track infrastructure may require charging on the basis of the goods being carried. But the track infrastructure company may not know or easily be able to find out what is inside the rolling stock running on its track. A further problem is that investment in new infrastructure (such as high-speed trains, or “tilting” trains) may require close co-ordination between the track and train companies, co-ordination which would normally be more efficiently carried out within a single firm. Finally, the transition costs of carrying out the separation may be substantial. In the UK the process of establishing arms-lengths contracts between previously integrated companies was a huge legal challenge – in fact the largest single commercial law project in the UK’s history.

The problems associated with full separation of the infrastructure from train operations can be reduced by allowing the track infrastructure company to run trains of its own (*i.e.*, allowing the incumbent company to remain vertically integrated). The problem in this case is that the incumbent company has a strong incentive to discriminate against rival train operating companies. The regulator needs to be active and vigilant if it is to overcome these incentives and it may never completely succeed in doing so.

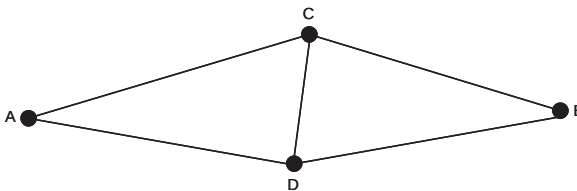
Despite the theoretical potential for competition under this approach, in practice, so far relatively little or no competition has developed in those countries (the UK and Sweden) which have adopted this model.

3.2. *Horizontal Separation – Competition between vertically-integrated railway companies*

The other major alternative approach relies primarily on competition between competing vertically-integrated railway networks, which offer alternative routes between the same source and destination. Ideally, under this approach, these networks would be chosen so as to give nearly every shipper a reasonable choice between rail companies for the products and the routes covered by that shipper.

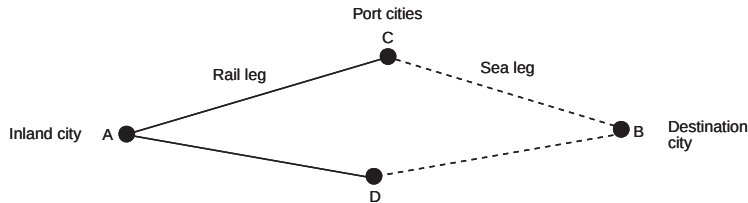
However, even with careful attention to the design of the networks, there will be some shippers which can still effectively use only one railway network. The market power of that railway network could be controlled by various regulatory safeguards such as a rule allowing shippers within a certain distance of a point of connection of two networks to have their goods carried to the point of inter-connection. Those remaining shippers which genuinely have no choice of rail company might be protected through regulatory caps on the rates the railway company can charge. Some shippers will be protected *by* “*ex ante* competition” – *i.e.*, the ability to negotiate competitive rates with different railroads before sinking investment in a particular location tied to a particular railroad. Finally, in certain places the infrastructure may not allow rival networks, particularly in and around major cities or freight terminals. In these places consideration could be given to establishing mechanisms to ensure non-discriminatory sharing of the “essential” facilities (as in the example of the joint ownership of the main rail terminal in Mexico City). Indeed, there may be an argument for keeping within one network all of the rail lines within the immediate vicinity of the larger cities (such as Moscow), to ensure that passenger commuter rail services are maintained throughout the transition process.

This form of competition between rail companies can be illustrated in the following way. In the simplest case, if there are major traffic flows between two cities “A” and “B”, there may be two distinct rail lines joining these cities, perhaps one path via city “C” and one path via city “D”. By separating the rail network so that the rail line ACB and ADB are operated by different companies, these companies will compete for the business of the shippers in the cities A and B. Furthermore, by requiring sharing of the rail spur joining C and D, shippers at C and D will also have a choice of rail company for moving their goods to A and B.



There will not always be such “parallel” rail lines within Russia on all major trade routes. But this is not necessarily an obstacle. If the major trade routes involve a sea leg, the railways within Russia can compete in the transportation of goods to different ports from where they are transferred onto ships for the rest of the journey to the destination. For example, if there are two different rail links

from city A to port cities C and D, by separating the rail links AC and AD into different companies, shippers at A have a choice of railway companies for shipping from A to B.



In this example C and D could also be border cities on a land border, which are served by distinct rail links to and from the city B in the foreign country. Again, separation of AC and AD allows competition in shipping of goods between A and B. Mexico has pursued separation of this kind – all of the three major railroad companies have access to ports on both the Pacific and Caribbean and two northern railroads each have access to border cities with the US.

Finally, we can mention that even if there are not different “parallel” routes to the destination, the market power of the competing railroads can still be constrained by what is known as “source competition”. Even if a shipper only has a choice of one railroad to get its goods to a market, those goods will often compete with goods from other sources at the destination market. The ability of a railroad to exercise market power is constrained by the need to ensure that the goods remain competitive in their final market.

As an initial impression, the Russian rail network, especially west of the Urals, appears sufficiently dense as to offer the prospect for several overlapping rail networks on each major trade route, especially to the west, north and south.

It is worth mentioning that the competing rail companies are not necessarily limited to only operating on their own networks. Experience in the US shows that rail companies can and do negotiate with one another to agree the reciprocal running rights, allowing rail companies to serve shippers in a larger area than just their own network. Note also that the competing networks could offer both passenger and freight services. In addition, the networks may want to enter into joint ventures or alliances for the provision of freight or passenger services. They should be allowed to do so where competition is not impaired.

Competition between vertically-integrated railway companies has a very long history in North America. Despite the consolidations that have taken place in the US and Canada in recent years, there remains sufficient competition so as to have

effective competition between rail carriers over a large part of that continent. The railways in Canada and the US are also among the most efficient in the world.

A primary advantage of this approach is its simplicity of implementation. The approach does not involve complex complicated contractual arrangements and requires relatively little regulatory intervention. Regulatory intervention is carried out on a case-by-case basis, protecting those shippers and only those shippers which are genuinely captive and face no alternatives. In addition, this approach is consistent with allowing independent companies to develop new specialised rail lines, such as high-speed passenger links.

3.3. Which approach for Russia?

Which of these two broad options is preferable in the Russian context? Competition authorities are typically supportive of vertical separation in a number of infrastructure industries. However, this preference for vertical separation only applies in those industries where in-the-market competition is not possible. It seems to us that genuine competition between rail operators is preferable to the establishment of a large monopoly in the track infrastructure and the regulatory issues that raises. On the basis of the information that was shared at the conference regarding the situation in Russia, it seems that the second approach offers significant potential. This approach is simple to implement and offers the promise of effective competition.

We have noticed that, independently of the OECD, in 1993 the World Bank recommended to Russia the development of competition within the rail sector via competing vertically-integrated railroads:

“Although intra-rail competition has not been common in Europe, it is the norm in North America, which has the world’s most efficient freight railway system. There is no single or simple approach to creating intra-rail competition. It could be accomplished by combining and then redividing the regional railways so there is direct competition between them. For example, it would be possible: *a*) to structure parallel line competition from Lake Baikal to Moscow and the western borders; *b*) to make the Eastern Siberia, Trans-Baikal and Far East railways into bridge carriers jointly owned by competing carriers west of Lake Baikal, ultimately yielding intra-rail competition over the entire route from Europe to Asia; and *c*) to grant the Moscow railway trackage rights over the October railway to St Petersburg and the Finnish border”.

The proposal of the Ministry of Railways does envisage some competition between rolling-stock companies. Under their proposal, companies will be allowed to sell transport services using the rolling-stock that they own, contracting with the Russian Railway company to provide the locomotive and track services. In our view, this competition, although better than nothing, is rather limited. The

Russian Railway company will remain in a strong position to control the volume of traffic and therefore the overall price level. Even if the rolling-stock companies are able to request the railway operator to put on more trains, the level of competition would not be the same as if other companies were allowed to operate their own trains, with the speed, route, price and quality level of their choice. Although the practice of allowing private companies to own and operate rolling stock should continue (and is common in other countries), in our view, a more thorough approach to the development of competition would be preferable.

Whichever approach is chosen it is critical that the competition authority (*i.e.*, the Ministry for Antimonopoly Policy) be active in this sector to protect the competition that exists and to prevent anti-competitive behaviour, whether unilateral or collective.

In regard to control of the prices of rail services, as competition develops control of rail prices should be progressively withdrawn. Ultimately price controls will be limited to just those shippers which are genuinely captive (*i.e.*, have no alternatives). As far as possible, railway companies should have the freedom to charge different prices for different products and different routes, according to the nature of the services provided and the degree of competition from other transport modes. The overall level of prices can be controlled through a cap on the overall basket of prices charged by the railway company.

Our recommendations can be summarised:

- *Promotion of intra-rail competition* – the railway reform should seek to promote competition within the rail sector, between independent railway companies (and not only between rolling-stock companies).
- *Separation* – the existing railway company should not operated as a single monolithic entity. It should be divided up in a manner which promotes competition. On the basis of the information available to us at this time we consider that the approach which offers the most promise for promoting competition is to divide the railway up into a number of vertically integrated railway networks in such a way that important shippers are served by at least two (and preferably more) different rail networks. Whether separation into vertically-integrated railways is the most appropriate choice will, however, depend upon factors such as whether the existing network is sufficiently dense to allow a sufficient level of competition to be created and will need to be subject to further study based on accurate accounting and route usage information.
- *Sharing of essential facilities* – whichever mode of separation is chosen facilities which cannot be duplicated and are essential for competition should be shared or should be subject to access rights.

- *Protection of captive shippers* – whichever mode of separation is chosen captive shippers should be protected through access rights or through a price ceiling, imposed by the regulatory authority, on the rate the railway company can charge.
- *Role of competition authority* – the competition authority should be involved throughout the reform process, the transition and the implementation to protect competition and to control anti-competitive behaviour.
- *Control of prices* – price controls should be progressively withdrawn as competition develops. In the transition process, railway companies should have the flexibility to set different prices for the transport of different products, which can be achieved by controlling the level of a basket of prices, rather than individual prices.

We understand from the seminar that relatively little attention has been paid until now to the possibility of competition between rival integrated railway companies. We therefore urge careful consideration of this approach.

4. Managing the transition

Whichever approach is chosen, the ultimate success of the reform will depend, in part, on the success of the transition process. It is important, therefore, that attention is paid to this phase. The transition process should be long enough so as to have the time to carry out the required tasks effectively and efficiently, but not so long as to delay the reforms, delaying new investment and risking further deterioration in the rail situation in the interim.

We would envisage a three-phase approach. In the first phase a preliminary separation plan would be developed. This process would involve identifying the major trade routes, the location of major shippers and the important destinations for goods. The plan would be prepared with the objective of ensuring that, as far as possible, shippers would face a choice of at least two competing railways. At the same time, any key or essential facilities would be identified and plans for sharing or access arrangements determined. Once the government is satisfied that sufficient competition could be developed, the existing rail company would be divided administratively into a number of competing rail companies and then corporatised, along the lines set out in the plan.

In the second phase, these rival rail companies would be operated, on a commercial basis for a period of time. This would give these companies the opportunity to improve productivity and profitability (such as divesting loss-making lines and reducing staffing levels) and to produce audited accounts to an international standard. This phase would also provide an opportunity for learning, testing and demonstrating the viability of the newly created companies. Any problems that arise would be addressed before proceeding to the final stage.

In the final phase, the right to manage and operate these companies would be tendered to the private sector. This does not necessarily require the sale of core government property. Rather the state could simply tender the right to provide services and to operate and maintain certain specified parts of the infrastructure. The state could retain the formal title to the underlying rights of way. This was the approach adopted in Mexico. In Mexico, the rights or “concessions” were issued for a period of 50 years. Potential bidders were required to commit to a certain level of new investment. The auctioning process raised US\$2.4 billion and involved a commitment from the new operators to invest US\$1.3 billion.

5. Conclusions

The reforms proposed by the Russian government go a substantial distance towards placing the Russian railway on a sound commercial footing. This alone is an important step forward. However, the proposed reforms involve a substantial degree of centralisation into a single entity – the Russian Railways company. The scope for competition within the proposed structure is rather limited. The current reform process represents an opportunity to promote the introduction of real competition into the Russian rail system. We recognise that there is more than one way to do this. In our view, the possibility of competition between integrated railway companies should be seriously considered. This approach offers the real possibility for reducing rail prices, increasing rail productivity and making an increasingly important contribution of the rail sector to Russian growth and overall economic welfare.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(24 2002 21 1 P) ISSN 1560-7771 – No. 52465 2002