



OECD Journal of Competition Law and Policy



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Competition Law and Policy in the European Union (2005)

by

Michae Wise*

Competition policy played a central role in the development of the EU and its institutions. The European Commission, supported by the European courts, developed the framework for competition policy in Europe. This framework has been built since the Treaty of Rome in 1957 on a foundation of promoting market opening while strengthening the institutions of the European Community. The competition policy of the European Community is now in transition toward a basis in market-centered economic considerations, as well as on application through the now-extensive network of national-level authorities. The “modernisation” reforms of the enforcement process became effective in May 2004, along with changes in the control of mergers, and the Commission has been considering revisions to its policies about other topics, notably abuse of dominance and state aid. As the Member States adapt their substantive rules to those of the Community, the roles of the European Commission, the national competition agencies and the courts are changing. Co-ordination of enforcement among many agencies in the European Community, particularly concerning applications for leniency as part of cartel investigations, is increasingly important. The Commission moved to strengthen its capacity for economic analysis and to correct weaknesses in its decision process that had been revealed in critical court decisions. The challenge to this system, well adapted for administrative application, is to produce results that are convincing to the courts while maintaining policy consistency in a system of decentralised enforcement. This report served as the basis for a peer review in the Competition Committee in 2005.

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Executive Summary

The European Commission, supported by the European courts, developed the framework for competition policy in Europe, building on a conceptual and legal foundation of promoting market opening and strengthening community institutions. The competition law of the European Union is now in transition toward policy based on market-centred economic considerations, relying more on application by the now-extensive network of national-level authorities applying broadly consistent substantive rules. Substantive doctrines are adapted to administrative methods of application, as regulations and guidelines increasingly follow an analytic format based on an economic perspective.

Anticompetitive agreements are prohibited and void, and something close to a *per se* rule can be used against hard-core conduct, though economic benefits can lead to exemption from the prohibition. Enforcement against cartels would be strengthened further if sanctions applied to individuals as well as firms; if that is not feasible under Community law, the Commission could promote and support the imposition of individual sanctions under the national laws of Member States. Most restraints in agreements about supply and distribution are permitted, unless there is market power.

Curbing abuses by firms that dominate markets and suppress competitors or harm consumers is the other main subject of Community “antitrust” law. This area of law is due for modernisation to adapt it to the Commission’s more economics-centred approach, to focus on likely or actual market foreclosure effects more than on formally defined prohibited behaviours. In adopting an economic approach to dominance, liability should depend upon effects that harm competition; in appropriate cases, assessing the scope for recoupment should be an integral part of such an approach.

The inclusive legal standard for merger control can deal with all kinds of competitive effects. The Commission’s 2004 guidelines about horizontal mergers imply strong harmonisation in approach across the Atlantic, at least for horizontal combinations. But the courts’ critical response to several Commission merger control actions revealed weaknesses in its decision process, which the Commission has moved to correct by increasing its capacity for economic analysis and strengthening its internal quality controls. These checks, with which the Commission is still experimenting, improve quality but can increase costs. Nonetheless, a further increase in economic analysis capacity is called for.

Executive Summary (cont.)

The administrative process for applying the law is adapting in order to strengthen investigative powers and better incorporate economic evidence in decision-making, and thus convince the courts while maintaining policy consistency in a system of decentralised enforcement. Member State competition agencies and courts can apply Community substantive law, and the informal “European Competition Network” (ECN) is the medium for facilitating inter-agency co-ordination. Modernisation of the enforcement process, by eliminating notification and prior approval of exemptions while sharing enforcement responsibility with national agencies, is designed, among other things, to redirect resources so that DG Comp can concentrate on complex, Community-wide issues and investigations. A high priority here is to clarify the relationships among the leniency programmes of the Community and the national enforcement agencies.

Coverage of Community competition law is broad and generally consistent, with no sectoral exclusions and few provisions for special enforcement processes. Treaty provisions that prohibit Member State measures contrary to Treaty rules about public undertakings and undertakings with special or exclusive rights have been the foundation for the long-term liberalisation program to reform traditional infrastructure monopolies. Treaty principles about controlling State aid try to prevent competition-distorting actions by national public authorities. The Commission’s new program for impact analysis of EU legislative proposals that might affect competition in the internal market is turning attention to avoiding unnecessary and disproportionate restrictions on competition in the legislation of the EU.

1. Foundations

The competition law of the EU responded to Europe’s mid-century economic conditions. Its development, driven by the imperative of market integration, profited from the symbiosis between the protection of competition and the promotion of open trade. Decisions of the European Court of Justice (ECJ), pursuing the goals of strengthening the community and eliminating trade barriers, established the legal framework underpinning an ambitious Community competition policy. The European Commission’s Competition Directorate (DG Comp, formerly DGIV) is in a nearly unique position in the European Community system, because in the area of competition policy the Commission can apply direct enforcement power that is not dependent on national governments. Community competition law is undergoing a profound transition, after moving beyond the initial goals of opening markets and establishing a competition culture to become a mature, comprehensive

enforcement structure centred on the European Commission. The substantive principles that the Community institutions developed have now become a common legal framework shared with the national laws of the Member States. In the future, the law will evolve within the network of national and Community agencies that share responsibility for applying it. The principal focus of this study is the European Commission, as the administrative organ of the 25-country European Union. Most of the discussion would also apply in the context of the EEA, with its 3 additional countries and closely co-ordinated competition policy and enforcement.¹

1.1. Context and history

In post-war Europe, administered economies faced development needs and state monopolies. The institutions of the European Union were created in a context of state intervention through ownership and control over trade and prices, as Europe was rebuilding after depression and war. The designers of the new post-war political economy framework, seeking to expand and integrate markets and sustain development, concluded that competition policy would be a necessary element of the new structure, principally to curb abuses of national monopolies.

The framework developed as a treaty group of states. Characterising the legal status of the European Union and comparing it to other institutions have become complex tasks as functions have evolved.² In those aspects of its operation that are dependent on consensus, it resembles an international organisation of states coming together to promote co-operation. In other aspects it resembles a federal government, capable of applying powers directly. The development of competition policy and the direct application of that policy by the Commission represent such federal tendencies. Those tendencies also appear in rulings of the ECJ that establish the supremacy of Community law and require national courts to apply Community law as their own (Hartley, 1994).

The concepts and institutions of EU competition law appeared first in the European Coal and Steel Community (ECSC). The need to stabilise Germany's post-war economy and integrate it into western Europe, while preventing German firms from dominating markets, was most evident in the key coal and steel sectors. A new legal entity, the ECSC, was created by the 1951 Treaty of Paris to administer these sectors. The ECSC included most of the elements that were later incorporated into EU competition policy.³ The terms of its rule prohibiting restrictive agreements while permitting exemptions pioneered the now-familiar language. It also set the benchmark for sanctions that is still the norm, of an administrative fine up to 10% of annual turnover. The ECSC prohibition against restrictive agreements, to be applied directly by the ECSC administrative body, appeared unusually sweeping. It was a clear departure

from the consensus approach that had emerged from pre-war discussion and experience about competition policy, to register cartels in order to control abuses rather than prohibit them outright. By contrast, the ECSC treatment of dominant firm conduct more closely resembled the pre-war consensus, of correcting abuses by controlling future practices and prices (after consultation with the Member government concerned). ECSC provisions about “interference with conditions of competition” regulated government subsidies and assistance, foreshadowing the Common Market’s rules about state aids. The ECSC competition law system also required prior approval of mergers; however, the merger rules, the only part of the ECSC system that reflected US experience, had little influence on later developments.⁴ The ECSC became effective in 1953. Its competition provisions were not actually applied very much during the 4 years before the Treaty of Rome established the broader Common Market in 1957.

The Common Market used the ECSC as a model for basic policies and rules. The discussions preparing the European common market recognised that controlling anticompetitive practices was a critical prerequisite. The preparatory documents described the problems of monopoly and the need for rules against discrimination, market division and suppression of output or technology. The fundamental goals that the Treaty of Rome set for the Common Market include preventing national discrimination and establishing a system to ensure that competition is not distorted. The competition rules in the Treaty of Rome build on those of the ECSC about agreements, dominance and subsidies, though not the ones about merger control. The rules for the Common Market add some precision to the prohibition of restrictive agreements, while strengthening rule against abuse of dominance into a prohibition. These basic articles were conceived as constitution-like, anticipating that their content would be determined in practice. Generality was also prudent, as the Treaty necessarily bridged or avoided some differences among the Members’ views. Some favoured a strict competition law and envisioned the Treaty rules as legal norms to be applied in judgments by courts. Others saw the Treaty provisions as programmatic statements about policy intentions to guide administrative discretion (Gerber, 1998).

The Council gave the Commission broad powers to develop and apply the law. The Member States did not focus on competition policy very much during the 4 years it took to prepare the regulation to implement the Treaty rules, and thus the Commission ended up with more autonomy in this area than it might have otherwise (Goyder, 1998). The 1962 enforcement regulation centralised responsibility in the Commission. Its approach to cartels emphasised the Treaty’s prohibition, because obtaining an exemption required a decision from the enforcer. It carried over from the ECSC process the possibility of obtaining a negative clearance decision, but it did not provide for an “opposition”

procedure (under which inaction by a deadline would constitute approval or exemption). Between 1957 and 1962, some national agencies had begun to apply the Treaty provisions.⁵ But the Council enforcement regulation marginalised the national agencies and courts by giving the Commission priority in investigations under Community law and exclusive competence over the key subject of exemptions. The Commission had to consult about enforcement actions with a committee of representatives from the Member States, but the committee's views were advisory, not binding. The Council rejected a proposal to give this committee veto power. When the system was implemented in 1962, the Commission received over 35 000 notifications requesting exemption or negative clearance. Case-by-case response proved impossible; general rules were obviously needed instead. The block exemption regulation of 1965 responded to the overload, while underscoring the Commission's autonomy in competition policy. The Council delegated authority to the Commission to issue regulations setting generally applicable objective standards for exemption from the cartel prohibition. The Council has not delegated such authority to issue regulations to the Commission for any other substantive field.

With encouragement from the judiciary, competition law framed an economic constitution. In the process of decision and appeal during the first decades of Community competition law enforcement, the dialogue between the Commission and the ECJ set the direction and scope of competition policy. ECJ support for broad interpretation and wide application of the Treaty competition provisions has been fundamentally important. The Commission did not face the narrow, technical limitations on jurisdiction or power that some national courts have imposed on new competition agencies. Instead, the ECJ supported expansive claims of competition policy jurisdiction, because they implemented the Court's goals of promoting market integration and strengthening the institutions of the common market. The Court's encouragement of the Commission in setting the terms of market integration gave the Treaty rules about competition a quasi-constitutional status.

The Commission moved carefully at first. Decisions might expand jurisdiction because of potential effects on trade, then balance that expansion by some narrowing of the basic prohibition. The Commission concentrated on jurisdictional and procedural questions, avoiding heavy fines and aiming enforcement toward private firms more than state-owned companies. The 1964 *Convention Faïence* case illustrates the commercial context that the Commission faced: a complex of obligations and constraints upon members of a trade association effectively cut off a national market from significant imports. The case was resolved in characteristic fashion, with a negotiated undertaking to transform the cartel into an open-entry venture. Distribution agreements dominated enforcement attention, while recurrent controversies about

parallel imports also highlighted the importance of the market-integration goal. That goal explains and probably justifies the priority given to vertical matters; however, as a consequence of that choice, “not until some years later did the Commission get to grips with some of the major horizontal cartels that had operated with impunity” (Goyder, 1998, p. 70).

Increasing confidence in EU competition policy culminated in the 1989 merger regulation, completing the European competition-policy “toolkit”. After 20 years of laying the foundation, by the 1980s the Commission was taking stronger enforcement actions. The single-market program and the Single European Act of 1986 reinforced the market-integration objective and thus provided additional momentum for active competition policy. Merger control, which the drafters deliberately omitted from the 1957 Treaty, was finally adopted by a Council regulation after 17 years of effort. Business supported this move to establish a single point in Europe for regulation of large-scale mergers. Implementation involved a process of adjustment. The first time the Commission prohibited a merger, in 1991, governments where the firms were located protested. It took some time to overcome the early impression that political factors could play a role in Commission merger actions (Gerber, 1998). Wielding this significant power to affect key business decisions bolstered the visibility and prestige of Commission competition enforcement generally.

State interventions and monopolies drew increasing attention. A line of cases dating from 1985 invoked basic Treaty obligations against national legislation that interfered with the effective operation of the Community’s competition law. The Commission’s program to encourage reform of monopolies in infrastructure service sectors began with telecommunications. Here again, the courts supported the Commission’s initiative. The ECJ’s 1986 *Telecommunications Terminals* decision distinguished between inherently governmental and essentially commercial functions, narrowing the exemption for public services and permitting a Commission action for abuse of dominance against British Telecom. A directive to eliminate monopoly rights that harmed competition followed in 1988, expanding on previous directives that had required more transparency about state owned enterprises. Other decisions in the Commission’s liberalisation program since then have addressed postal services, mobile telecommunications, airports, ports and maritime transport, insurance and broadcasting, while the Council has issued legislation in the form of directives calling for reforms in telecommunications, energy and postal services.

Community competition policy is now being reshaped in terms of economic principle. In this project, which has been underway since the mid-1990s, the Commission is building on the increasing reliance on economic reasoning and analysis demanded by merger control and the liberalisation program.⁶ With

the market integration goal largely accomplished concerning industry and trade, attention shifted both to the constraints on trade in services and to the standard competition policy fare of cartels and monopolies. The shift in enforcement focus entailed a shift in analysis away from formal categorisation. The foundation for the economic reconstruction was laid in the 1997 guideline about the definition of a relevant market. The first major substantive projects were the complete revisions of the rules about vertical and horizontal restraints, replacing long listings of specific requirements and prohibitions with general principles and market-share tests. The Commission is reformulating regulations and revising guidance to modernise Community competition law along these lines.

Closer judicial oversight led the Commission to improve its internal procedures. Addition of the new Court of First Instance (CFI) in 1989, which doubled the capacity of the Community's judiciary, provided a more practical avenue for parties to appeal Commission decisions. The Community courts remain supportive of the Commission's competition policy initiatives. But the CFI has rejected Commission actions for procedural errors and for defects in the quality of its reasoning and its treatment of evidence. When the CFI adopted rules permitting "fast track" review, it became practical for parties to seek judicial review of merger decisions too. About 20 merger cases are in some stage of appeal to the Community courts now (Vesterdorf, 2005). In 2002, the CFI rejected three Commission merger decisions within 4 months, in opinions that sharply criticised the Commission's economic analysis and its treatment of evidence. Partly in response to problems that these decisions revealed, DG Comp created a new special economic unit and accelerated the recruitment of industrial economists generally in order to increase its capacity for economic analysis, and it introduced additional quality-control checks into its processes of investigation and case evaluation.

After 40 years of experience, in 2004 the Community implemented a "modernised" enforcement process.⁷ By removing the Commission's monopoly on deciding about exemptions, the new system makes it much more practical to apply the law through national institutions and processes. The founding treaty envisioned enforcement co-operation between the Commission and Member State national authorities, at least as a transition measure. But of the original six, only Germany had a similarly ambitious competition law system at that time.⁸ Now, all of the Member States have competition laws and enforcement agencies, and their national substantive laws have generally converged on the Community standards. Some areas of divergence remain, and the new enforcement regulation deals with the questions of co-existence and supremacy. National law can be applied to conduct that meets the jurisdictional test concerning effect on trade between Member States, but the national authorities must also apply Community law at the same time, and national

law cannot prohibit restrictive agreements that would not violate the Treaty. But national law can be stricter than Community law concerning unilateral behaviour.⁹

1.2. Policy goals

The Treaty makes competition a principal goal, but it does not elaborate what the concept means. The activities prescribed for the Community institutions include several that directly implicate competition policy: to provide “an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital”, and “a system ensuring that competition in the internal market is not distorted” (Article 3). The Community and its Member States are to adopt a co-ordinated economic policy based on “an open market economy with free competition”. (Article 4). These parts of the Treaty thus set out the goal of free and undistorted competition for the Community’s internal market. The basic rules of Articles 81-87 do not limit the choice of policy goals. They do make clear that the competition rules address government measures as well as private conduct. The Treaty’s opening statement implies that the most fundamental objective of the Community can be understood as promotion of economic welfare and progress,¹⁰ with competition policy being one of several instruments for that purpose. Thus the Treaty text also includes policy goals that might be construed as inconsistent with promoting competition – although they are typically phrased in a way that implies there will be no need to choose. For example, Community institutions are to support industry competitiveness, in part by “encouraging an environment favourable to cooperation”; however, this provision is not to be taken as a basis for any Community measure “that could lead to a distortion of competition” (Article 157). Even the complementary fundamental free trade goal of the common market, embodied in the prohibition against controls on imports and exports, is not unqualified. Other policies that can justify national limits on trade are “public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; or the protection of industrial and commercial property” (Article 30).

The goal of promoting market integration was important when the common market was still being established. Where industries were traditionally established within national markets, the challenge was to get them to transcend those boundaries. The market integration goal explains the emphasis on vertical relationships and intellectual property rights, which were seen as obstacles to cross-border trade. That goal was the link in the Commission’s partnership with the ECJ. Policy developed with an emphasis on legal form, more than economic content, in part because of this partnership with the

courts and in part because of the influence of concepts from German competition law. One commentator concluded from these dynamics that the policy goals of Community competition law were not efficiency or equity, but legality in the service of market integration (Wilks & McGowan, 1996). With progress toward realisation of the internal market, the relative importance of the market integration goal has declined.

Policy statements now stress efficiency, consumer welfare and competitiveness. The mission statement of DG Competition sets out a number of possible goals, including in the same sentence both the welfare of consumers and the competitiveness of the European economy. Covering all bases, it contends that “[o]pen and competitive markets are an important means to increase the competitiveness of industry, stimulate technological development and innovation, and to provide consumers with lower prices, larger choice and better quality goods”. The 2000 Guidelines on Vertical Restraints declares that “the protection of competition is the primary objective of EC competition policy, as this enhances consumer welfare and creates an efficient allocation of resources. In applying the EC competition rules, the Commission will adopt an economic approach which is based on the effects on the market ... Market integration is an additional goal of EC competition policy. Market integration enhances competition ...”. The Commission’s guidelines about horizontal mergers detail the benefits to consumers, of low prices, high quality products, a wide selection of goods and services and innovation. These guidelines do not mention improving competitiveness. But the Commission’s 2004 annual report on competition policy, while mentioning the general notion of improving efficiency, highlights the Lisbon agenda to promote European competitiveness, being careful to note that “competition policy is not an end in itself, but one essential tool to achieve efficient market outcomes”.

2. Substantive issues: content of the competition law

Substantive doctrines are adapted to administrative methods of application. Regulations and guidelines now follow an analytic format based on an economic perspective.

2.1. Framework

The basic norms and rules are the text of the Treaty and actions taken by the Council. They thus represent political-level enactments taken by agreement among the Member States. The general rules about antitrust and state aid issues are in the Treaty text. Merger control rules are in a Council regulation. Directives adopted by the Council, which require implementation through the laws of the Member States, have been particularly important about liberalisation.¹¹

Regulations issued by the Commission, the administrative body of the Community, are important tools for implementing competition policy. The block exemption about vertical agreements in distribution, adopted in 1999, and its accompanying guidelines introduced the now-standard format of an explanation of analytical method and a compact set of clear standards or prohibitions, coupled with thresholds or safe-harbours based on size or market share. This approach considers implicitly the likely costs and benefits of the practices at issue, by including a proxy for the likelihood of market power or significant market impact. It also takes account of benefits for compliance and enforcement of making rules clear and concise. This new format is replacing regulations that had been criticised as excessively legalistic, typically comprising detailed “black lists” of terms that were forbidden and “white lists” of ones that were required or permitted. The Commission has issued revised regulations following this format about horizontal agreements, insurance, motor vehicle distribution and servicing and technology transfer agreements.

Decisions in individual cases demonstrate concretely what the general rules imply. Decisions are not generally treated as a source of substantive rules, although judicial opinions have created some widely used doctrines of Community law that are not found in the texts of the treaties or legislation. In competition law, ECJ judgments created the important doctrine that Community jurisdiction does not apply to practices whose effect on trade or on competition is not appreciable. More specific rules derived from the Court’s judgments could be somewhat unstable, for the ECJ does not consider its past judgments to be binding precedents (although it usually follows them).

Notices and guidelines follow the courts’ cases and indicate the Commission’s policy direction. As the courts stepped back from shaping substantive doctrines, the initiative shifted to the Commission, which has relied often on the “soft law” of guidelines and notices (Gerber, 1998). The Commission has issued such pronouncements about the interpretation of fundamental issues such as effect on trade and *de minimis* coverage, market definition, policies about setting fines and promising leniency, horizontal mergers, vertical restraints (elaborating on the regulation), technology transfer agreements, horizontal restraints and co-operation with national courts. Projects for similar restatements of principles and guidance are underway about other kinds of mergers, abuse of dominance and state aids.

Community competition law applies only if there is sufficient Community impact. This concept, which defines the limits of the Community’s legal competence and its boundary with the laws of the Member States, is interpreted expansively. The Treaty’s competition rules address conduct that “may affect trade between the Member States”.¹² The Commission’s Guidelines on the effect on trade concept, issued in April 2004 as part of the modernisation

package, collect doctrines from court judgments to define the cases that national agencies can handle without also applying Community law. If an agreement as a whole is capable of affecting trade, Community law applies to all of it, including parts that individually do not affect trade, and to all of the parties, including ones whose individual contribution to that effect would be insignificant. The jurisdictional test can be met based on the expected effects of potential competition and on positive as well as negative changes in patterns of trade. The further requirement that the effect be appreciable limits this broad scope, though. The Guidelines define what is not considered “appreciable” based on cumulative thresholds of market share (5%) and aggregate turnover (EUR 40 million). In general, these levels define a rebuttable negative presumption. Below those levels, the enforcer has the burden of showing that there is nonetheless an appreciable effect on trade in order to establish Community law jurisdiction over an agreement or practice. For agreements that “by their very nature” would affect trade, though, each threshold establishes a positive rebuttable presumption: above those levels, parties to such agreements have the burden of showing that there is nonetheless no appreciable effect on trade in order to avoid Community law jurisdiction. Virtually any agreement that controls imports or exports or that is implemented in more than one Member State would be covered by the positive presumption. There is also a clear presumption that an agreement or practice that covers all of a Member State meets the “affecting trade” requirement, because a cartel or abusive practice of such wide scope would necessarily affect the competitive prospects of potential competitors from outside. More judgment is called for in dealing with agreements or practices that apply only in a part of a single Member State. The Guidelines follow case law in denying that markets must be defined first before identifying jurisdictional effects, but they also refer to the Commission’s general Notice about market definition for the purpose of identifying these thresholds. Because one of the thresholds is based on market share, it may be necessary to define markets.

Community law applies to entities that are “undertakings”, determined by function. This defined term is interpreted broadly, based on the nature of activities rather than formal structure. It excludes the sovereign functions of a state, but it includes the state’s commercial activities. It thus includes state bodies engaged in commerce, nationalised industries, municipalities, trade associations, private individuals, co-operatives and associations. Economic activity, not profit, is the important element. Some close cases have involved social insurance funds. Factors that may lead to finding that such a fund is not an undertaking include whether it is compulsory and motivated by solidarity or redistribution. On the other hand, it is more likely to be considered an undertaking if it is potentially in competition with similar private-business entities.

A standard analysis for defining markets is used for the tests based on market power. The Commission's 1997 Notice on the definition of the relevant market for the purposes of Community competition law lays out systematically the considerations used to identify product and geographic markets. Legal criteria come from the enforcement and merger regulations. A relevant product market comprises all those products or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use. The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas. The method relies principally on demand substitutability, which is described as "the most immediate and effective disciplinary force on the suppliers of a given product." This is tested by examining the market's likely reaction to a 5-10% permanent relative price increase. Supply substitutability may also be taken into account where its effects are equivalent to those of demand substitution. Potential competition is not taken into account when defining markets, but may be considered in the competitive assessment. The guidance recognises that the market definition analysis might depend on the nature of the competition issue under examination. The focus in merger cases is prospective, anticipating market conditions in the future. By contrast, in dealing with restraints or abuse of dominance, the focus could be on present or past conditions, and it could include an examination of whether the conduct has affected conditions in the market and thus the evidence used to define it.

Anticompetitive agreements are prohibited and void, unless exempted. Article 81(1) prohibits agreements that have the object or effect of preventing, restricting, or distorting competition. The prohibition extends to decisions by trade associations and to "concerted practices". These terms are interpreted broadly, to include arrangements that are not legally enforceable contracts. The alternative characterisations, about the nature of the object or of the effect, also invite broad interpretation. But there are limits: for example, a supplier's arrangements with its customers may not be treated as a set of agreements if the customers had not acquiesced in the supplier's program.¹³

Small-scale agreements are not usually considered to be likely to affect competition. In a series of Notices issued since 1970, the Commission has limited the scope of the Article 81 prohibition by describing transactions that are likely to be too small to have appreciable effects.¹⁴ The latest such *de minimis* Notice sets thresholds based on market share at 10% for agreements between competitors and 15% for agreements between non-competitors. Where there are parallel networks of similar agreements in a market, the

threshold is lower, at 5%. The Notice also implies a collective threshold for that situation, stating that cumulative foreclosure is unlikely if less than 30% of the market is tied up in such parallel networks. Regardless of market share, hard-core agreements cannot benefit from *de minimis* treatment. The Notice's definitions of such hard-core agreements are the same ones used in the block exemption regulations and guidelines about vertical and horizontal agreements. The rationale for *de minimis* treatment is that competition concerns are unlikely if companies do not have a minimum degree of market power.¹⁵

Economic benefits from an agreement can lead to exemption from the prohibition. Under Article 81(3), 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. Improvements in productive efficiency obviously can be considered. Promoting progress could also include prospects for innovation that may be less immediately tangible. Neither "efficiency" nor "progress" implies a broad social balancing of economic advantages and disadvantages. Goals pursued by other Treaty provisions can be taken into account to the extent that they can be subsumed under the four conditions of Article 81(3). Guidelines from the Commission acknowledge that applying the 2 parts of Article 81 is a balancing process, seeking to identify the net economic effect of the restriction and the efficiencies. An increase in market power increases firms' ability and incentive to raise price, but cost efficiencies may permit them to reduce price. In balancing these potentially opposite effects, the requirement that benefits be passed on to consumers results in a sliding scale.

2.2. Horizontal agreements

The Treaty specifies some of the horizontal agreements it prohibits. The listing, which is not exclusive, includes direct or indirect fixing of prices or trading conditions, limitation or control of production, markets, investment or technical development and sharing of markets or suppliers. Decisions have clarified what else Article 81 prohibits. All forms of agreements to divide markets and control prices, including profit pooling and mark-up agreements and private "fair trade practice" rules, are prohibited. Exclusionary devices such as aggregate rebate cartels are prohibited even if they make some allowance for dealings with third parties. Joint purchasing and selling are permitted in some market conditions. Exchange of price information is permitted only after enough time has passed, and only if the exchange does not permit identification of particular enterprises.

Something close to a *per se* rule can be used against hard-core conduct. It is not necessary to prove that price fixing, market division or output limits or quotas actually raised prices or reduced output. Decisions have made clear that those effects are presumed, and parties to the agreements cannot overcome the presumption by claiming they had no intention or capacity to achieve an anti-competitive effect. The decision to fix prices is enough to establish the infringement. To set the fine, though, factors in addition to the nature of the infringement could also be relevant to showing the gravity of the offence. These factors could include the cartel's geographic scope and its impact, if that can be measured. Showing implementation of the cartel agreement would not require evidence of marketplace effect; for example, it would be enough to show that the colluders announced agreed price increases or met to monitor compliance. For hard-core infringements, the ECJ has agreed that factors related to intent may be treated as more significant than those related to effects.

Agreements that are tacit or undocumented may be prohibited as anticompetitive "concerted practices". This term covers co-operative activity short of explicit agreement, which the ECJ has described as "co-ordination between enterprises, that had not yet reached the point of true contract relationship but which had in practice substituted co-operation for the risks of competition". The term can include hard-core restraints. Cases about concerted practices typically look for evidence of arrangements for reaching and enforcing compliance with implied agreements to limit competition. The Commission has applied the concept to conduct that some other enforcers would treat as ordinary agreements, such as formal industry-wide market-sharing arrangements set up by trade associations. In this role, the term fills a conceptual gap in a legal tradition that privileges documentary formalism. But pure oligopoly interdependence would not be a prohibited "concerted practice".¹⁶ Intentional communication and awareness are needed, not just mutual awareness of the benefit of restraint.

Because Article 81 explicitly applies to "decisions" of trade associations, Community law can deal with this common setting for cartel agreements in a straightforward way. There is no need to infer constructive agreements or resort to theories of collective dominance. The decisions that Article 81 prohibits can include an association's formal rules or its more informal actions or recommendations. Where the infringement is attributed to the association, the Commission may nevertheless take into account the sum of the members' turnovers in calculating the association's fine. Under some conditions, the members may be liable for the payment of the fine by the association. The Commission will obviously go after the members for their own behaviour.¹⁷

In its application to non-hard core agreements, Article 81 resembles a rule of reason.¹⁸ The Article 81(1) prohibition and the Article 81(3) exemption

criteria require market analysis and balancing of positive and negative effects in cases of horizontal co-operation that does not amount to a hard-core cartel. The Commission has issued block exemption regulations about agreements for production specialisation and for research and development, accompanied by guidelines to show how Community law can allow competitor collaboration where it contributes to economic welfare without creating a risk for competition. The case law is not entirely consistent about whether the assessment of market conditions and consideration of potentially competing policies and effects are part of determining whether Article 81(1) prohibits an agreement or of determining whether Article 81(3) exempts it.¹⁹ For non-hard core agreements, the ECJ has said that market conditions, market structure and the economic context determine whether Article 81(1) prohibits it. For a hard-core agreement, those considerations might come up, if at all, only to determine whether efficiency claims under Article 81(3) exempts it. Yet the ECJ's *Wouters* judgment found that not every agreement which clearly restricts competition necessarily infringes Article 81(1). The judgment took particular account of the context and objectives of the agreement. In the *Wouters* case, the court found that the objective included a public interest purpose, to ensure the integrity and experience of the providers of professional services, that was in the interest of consumers and the sound administration of justice. Where the effects restricting competition are inherent in the pursuit of such objectives and can be reasonably held to be necessary in order to ensure the proper practice of the profession, as it was organised in the Member State, the court found that the agreement was not covered by the Article 81(1) prohibition at all. The public interest criteria that the court invoked would also appear relevant to the issue of exemption under Article 81(3). The Commission's Guidelines state that the four conditions for exemption are exhaustive, so no other grounds can be invoked (Guidelines on the application of Article 81(3), para. 42). Nonetheless, the courts have made clear that the goals set out under other provisions of the Treaty can be taken into account where they can be subsumed under the conditions of Article 81(3). Conflation of the two aspects of Article 81 may spread, now that other agencies and courts can apply both of them (Goyder, 2003).

Assessment considers factors such as market power and market structure under both aspects of Article 81. The Commission's guidelines on the applicability of Article 81 to horizontal cooperation agreements explain the standard analysis of horizontal agreements in general and apply it to several common types. Determining under Article 81(1) whether the agreement could restrict competition involves determination of the nature of the agreement, definition of markets, and evaluation of market structure and market power, including considerations such as the nature of the products, market concentration, barriers to entry, stability of shares and the countervailing power

of buyers or suppliers. The horizontal guidelines presume that if parties have a low combined market share, co-operation is not likely to restrict competition. The guidelines do not prescribe a single rule, because conditions and effects can vary significantly, but they do suggest particular levels for some kinds of agreement. For agreements about joint purchasing and commercialisation (that is, selling, distribution and promotion), the guidelines set a safe harbour at a combined market share of 15%. High market shares will not necessarily be a concern for standardisation agreements, and the assessment focuses more on whether the standards could raise barriers to entry. No market share test is needed for agreements that, because of their very nature, are unlikely to reduce competition. This could be the case, for example, if the parties could not carry out a project independently at all, or if their agreement is about an activity that does not affect any relevant parameter of competition. At the other extreme, no market share threshold applies to the hard-core restrictions of price-fixing, output limitation and allocation of markets or customers, which are generally prohibited irrespective of the parties' market shares. The guidelines then explain the application of the cumulative Article 81(3) criteria about economic benefits and its caveats about sharing the benefit with consumers, indispensability of the restraint to achieving the benefit and not eliminating competition by dominating the market.

The block exemption regulation about specialisation treats production rationalisation in the same way that the guidelines treat similar practices which are not covered by the exemption. For agreements between competitors to specialise production, the regulation sets a market share threshold for exemption at 20% (for all parties combined, and subject to certain conditions, including the absence of hard-core restraints). The guidelines describe how the law would apply to analogous agreements for joint production (which are also covered by the regulation) and for subcontracting agreements between competitors. The guidelines refer to the same 20% combined market share threshold in explaining both the Article 81(1) test of effect on competition and the Article 81(3) test of whether economic benefits outweigh the effect on competition.

The block exemption regulation for research and development is generous, particularly to innovation that promises to create new markets. Agreements between competitors about research and development are exempt up to a combined market share of 25% (of the market for the product that is the subject of the joint research), subject to certain conditions and the absence of hard-core restraints. Here too, the guidelines about the application of the block exemption regulation use the same level to presume the lack of effect on competition and to explain why benefits would be presumed to outweigh harm to competition. If the collaboration is developing something for which there is not yet any market, the guidelines recognise that a successful first-

mover effort should not necessarily be seen as an elimination of competition, even though it could lead to huge initial market shares once the product is developed. Thus, the block exemption permits such agreements to continue regardless of market share for the first 7 years after the product comes to market. At that point, the safe harbour of 25% applies.

Enforcement of Article 81 developed in an environment that had tolerated formal industry co-operation, sometimes amounting to self-regulation. Early cartel cases targeted national-scale industry associations and substantial international agreements about quinine, dyes, aluminium and chemicals. Some cartels had formal committees that kept minutes of their agreements. For other cases, obviously co-ordinated market actions could support an inference of agreement. Collection and exchange of information about price and output through trade associations has been a concern, as a means of tacit or even explicit co-ordination to confirm and police agreements. By the early 1990s, some cartel cases had resulted in total fines of over EUR 100 million. As the fines for price fixing mounted, Commission enforcement strategy began relying increasingly on insider evidence supplied by firms seeking clemency. This was formalised in the Commission's 1996 leniency notice, publicly announcing what had been an unofficial practice.

The level of enforcement against horizontal cartels has sharply increased since 2001. The Commission has issued an average of about 8 decisions per year, compared to fewer than 2 per year over the previous decades. The Commission's notice about setting fines treats hard-core cartels as "very serious infringements", for which the fine, determined by gravity, would normally be at least EUR 20 million (before considering other factors). The fines imposed in these recent cases confirm that treatment. In 31 Commission cartel decisions since 2001, the fines totalled EUR 4 billion. The peak was in 2001, with EUR 1 836 million. The level then dipped, and in 2004 the total was about EUR 390 million. Despite the increased activity, the fines being imposed may not yet be enough to deter hard-core infringements.²⁰

2.3. Vertical agreements

Most restraints in agreements about supply and distribution are permitted, unless there is market power. The 1999 block exemption regulation for vertical co-operation agreements restated the Commission's analysis of these restraints. Recognising that parties typically enter agreements to manage the distribution chain in order to improve efficiency and that smaller-scale agreements are unlikely to affect competition either upstream or downstream, the regulation applies a market share screen. It exempts most agreements involving a supplier or buyer with a market share under 30%, considering that to be a level at below which vertical agreements would be expected to lead to an improvement in production or distribution and allow consumers a fair share of the resulting

benefits (as long as they do not include certain particularly harmful restraints). The buyer's share of its downstream market is considered where the contract requires the supplier to sell exclusively to that buyer. Vertical agreements involving associations of retailers are also exempted, as long as the turnover of each is below EUR 50 million. Where parallel, similar networks of agreements account for more than 50% of a market, the Commission reserves the power to disapply the exemption, on 6 months notice; it has not yet done so, though. There is no presumption of violation where an agreement involves a supplier with a share over 30%. But with increasing market power come increasing concerns that agreements might impair competition, by foreclosing other suppliers, raising barriers to entry or reducing interbrand competition and facilitating collusion. The regulation also notes possible concerns about reducing intrabrand competition and about creating obstacles to market integration. The regulation applies to many types of agreements, replacing previous notices and regulations about topics such as exclusive distribution and franchising. Unlike previous regulations of similar topics, it does not contain a list of permitted clauses, an approach which had tended toward uniformity of practice out of a fear that whatever was not permitted would be prohibited. The vertical block exemption regulation takes the opposite position: below the 30% threshold, whatever is not prohibited is permitted.

Fixing minimum resale prices and excessive territorial protection remain black-listed, regardless of low market share. Resale price maintenance has always been treated as a *per se* infringement, at least with respect to minimum prices; however, recommending a resale price or requiring resellers to respect a maximum resale price are exempted, up to the 30% market share threshold, provided that the result is not a fixed or minimum sale price due to pressure from, or incentives offered by, the supplier. Territorial resale constraints are suspect, but some are permitted, to protect systems of exclusive dealership, preserve functional distinctions between wholesalers and retailers or prevent resale of components leading to competition with the supplier.

Provisos in the general rules address issues that arise in selective distribution systems and franchising. The regulation and accompanying guidelines do not dwell on the nature of the product for which suppliers may select and limit distributors. They do make a distinction between qualitative and quantitative criteria for selection. Qualitative criteria support selecting distributors on the basis of objective criteria determined by the nature of the product, which justify requiring distributors to demonstrate technical competence and provide suitable facilities. Quantitative criteria limit the potential number of dealers, for example by requiring minimum or maximum sales or even fixing the number of dealers. The regulation does not try to distinguish between claims for special treatment about technically complex or

dangerous products and those about luxury or image goods. Systems that apply objective, qualitative, non-discriminatory criteria for selecting distributors do not infringe generally Article 81(1). Selective distribution may be combined with exclusive territories and location clauses, but only if the buyers are permitted to market to consumers outside their territory. Thus the guidelines treat a ban on internet sales as a forbidden hard-core restraint. The guidelines underline the connection between the economic approach to vertical restraints and an economic appreciation of consumer information needs. Restraints may be more acceptable when applied to new or complex products whose qualities are difficult for consumers to judge before purchase and consumption (and for “credence” goods, whose quality consumers may not be able to judge well even after consumption). Most distribution and service franchises are evidently included in the block exemption regulation. How much the exemption applies to franchising is somewhat uncertain, though, because it does not cover agreements that are primarily concerned with intellectual property rights.

Sector-specific regulation governs vertical relationships in motor vehicle distribution and servicing. Lobbying and then recalcitrance led to a separate regulation for this problematic sector. The 2002 regulation is the Commission’s third effort to break down constraints that have tended to prevent parallel imports, limit consumer choice for cars and service and dampen price competition within and between national markets. The latest regulation followed a series of infringement actions that imposed fines totalling EUR 276 million. At the time (1998), the EUR 102 million fine against Volkswagen was the largest fine the Commission had ever imposed against an anticompetitive restraint. (The CFI later reduced this fine to EUR 90 million.) The experience persuaded the Commission to take a tougher line in this sector than the general vertical restraints regulation.²¹ The “black list” of forbidden clauses is unusually long and detailed. Manufacturers do not benefit from the block exemption if they do not allow their authorised dealers to sell competing brands or if they limit the dealers’ ability to open secondary outlets in other territories. The regulation applies the same market-share safe-harbour, of 30% (and 40% for a selective distribution system with a limited number of distributors), and it permits suppliers to use an exclusive system, but only if the system imposes no constraints on making passive sales to customers in other areas.

2.4. Abuse of dominance

Curbing abuses by firms that dominate markets and suppress competitors or harm consumers is the other main subject of Community “antitrust” law. Article 82 prohibits the abuse of a dominant position. Some acts that the Treaty lists as abuse are 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. Other kinds of conduct by a dominant firm that disadvantage other parties in the market could also be abuses.²² Practices such as loyalty rebates that would not be objectionable when done by a firm without market power could be considered abuses when done by a firm in a dominant position. To find infringement it is not necessary to show that an abusive practice produced an actual anticompetitive effect; it is enough that the conduct, when undertaken by a dominant firm, tends to restrict competition or is capable of having or likely to have that effect. There is no provision for exemption, although the case law has developed a doctrine that otherwise abusive conduct is not prohibited under Article 82 if it is “objectively justified”.

Dominance is a broader concept than economic market power over price. It is not the same as economic monopoly, although a monopoly would clearly be dominant. Dominance is often presumed at market shares over 50%, and it may be found at lower levels depending on other factors. The ECJ’s *Hoffman-LaRoche* (1979) and *United Brands* (1978) judgments explained the meaning of dominance under the Treaty, describing it as a “position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers”. These still-authoritative judgments found dominance based on features such as vertical integration, because that enabled a firm to act independently of its suppliers of intermediate services, and at market shares of 40-45%. In current practice, there appears to be a safe harbour at a market share of about 25%²³ and a rebuttable presumption of dominance at about 40-50%. Dominance depends on factors other than market share, such as the number and relative size of other firms and the conditions of entry. A finding of dominance is more likely if entry is difficult or if there are no other firms of comparable size or with the capacity to counter the leader’s strategies. Some recent actions imply that especially close attention will be paid to the conduct of “super-dominant” firms with shares over 90%. That treatment would confirm that dominance is subject to a sliding scale (Goyder, 2003).

Article 82 is not limited to single-firm misconduct. Under the theory of collective or joint dominance, several firms can share and abuse a dominant position. When the Commission first tried to apply Article 82 to oligopoly, the Court of First instance rejected the argument (although the court upheld the finding of infringement under Article 81 as a restrictive agreement). To find that several firms together hold a dominant position, the court demanded that the firms be “united” by “economic links”, such as a network of interdependent

intellectual property licenses. A formal cartel could possess collective dominance. Judgments applying the analogous language about dominance in the Merger Regulation, which have been cited as authority for the application of Article 82, imply that oligopoly interdependence might amount to collective dominance if the members could monitor each other effectively, if retaliation against defectors was credible enough to provide each member with an incentive to maintain co-ordination and if customer and consumer responses would not undermine co-ordination.

Exploitation of market power by charging high prices could be an abuse, although no final decision has actually condemned it. In the 1970s, reviewing Courts annulled 2 Commission decisions that had challenged high prices as abuses. The early Court judgments about abuse of dominance agreed with the principle, though, that “unfair” pricing could include setting prices to take advantage of market or monopoly power. Prices would be too high if they bore no reasonable relation to the economic value of the product. The ECJ has also endorsed the concept that Article 82 could prohibit prices for licensing intellectual property rights that are “particularly high” and “not justified by the facts”.²⁴ Despite the theoretical support for the sweeping principle, in the end the decisions have declined to find infringements based upon the evidence in the cases.

For predation, anticompetitive intent can be inferred from prices too low to recover costs; the strength of the inference depends on the cost reference. Prices below average variable cost are presumed to be predatory, that is, intended to eliminate competitors. Prices above that level that do not recover total costs may also be treated as predatory, but that conclusion may depend on further evidence of the intent to eliminate or prevent competition. “Super-dominance”, that is, extremely high market shares, may also be a relevant circumstance. Thus, the Commission has applied Article 82 against the collective “fighting ship” tactics of members of an ocean shipping conference, even though the prices were not demonstrably below costs. There is no recoupment requirement. The ECJ has endorsed the Commission’s view that it need not demonstrate that the dominant firm will succeed in raising its prices after its predatory tactics have weakened or eliminated its competition. The Commission recognises that recoupment could be relevant, though. For example, a recent decision about ADSL pricing pointed out that entry barriers would enable the predatory firm to recoup its losses. Cross-subsidy can support predatory tactics, and thus the Commission has addressed the asymmetric financial advantages of one-time public monopolies. The Commission accepted a commitment from *Deutsche Post* to effect a corporate reorganisation in order to make financing transparent. It implies a general principle under Article 82, that a statutory monopoly setting up a new business must cover the entire incremental cost from the revenues of that new business.

Discrimination is included among the abuses listed in the Treaty text, which prohibits putting other parties at a competitive disadvantage through the application of dissimilar conditions to equivalent transactions. This language implies some common principles of competition laws about discrimination, notably that the discrimination must be between transactions involving the same product or service and that it must actually cause competitive harm. The harm could be to an individual competitor, though, and not necessarily to competitive conditions in the market. Price variations that correspond to different national markets have been treated as prohibited discriminations, in the absence of objective justification in terms of differences in costs or in the extent of the seller's exposure to different risks in different markets. Decisions have prohibited discriminations about inputs that impose a "price squeeze" on non-integrated competitors or that unfairly favour national-champion incumbents.

Putting pressure on customers to enter into requirements contracts can be an abuse. Many cases have dealt with the foreclosure effects of loyalty rebates. Loyalty programs may be permitted if they are based on cost efficiencies. Only cost savings to the supplier can justify quantity-based rebates. Indeed, recent decisions imply that the only way to avoid liability is to base the loyalty scheme strictly on cost differences. Refusal to supply a customer can be an abuse, particularly if the customer is a long-time regular trading partner, but a reasonable justification, such as the customer's poor credit, can overcome the prohibition.

The prohibition of tying is implied in the Treaty text, which prohibits imposing non-germane conditions in contracts. The elements of tying, or refusing to supply a product unless the customer also takes another, allegedly unnecessary one, are dominance in the tying product, a separate tied product, coercion to take them together, an anti-competitive effect in the market for the tied product and the absence of an objective, proportionate justification for the tie. Bundling, which can make the price of the tied product effectively 0, can be construed as coercion. The most prominent application of Article 82 to tying tactics is the Commission's 2004 action against Microsoft.

Refusal to licence intellectual property, under some circumstances, can violate Article 82. The leading case reaching this result emphasised that the refusal prevented the production and marketing of a new product for which there was a potential consumer demand. The ECJ later refined the conditions for finding liability. The firm seeking the license must not be intending essentially to duplicate what the owner of the right already offers, there must be a potential consumer demand for the firm's product, the refusal to license must not be justified by objective considerations; and the refusal must prevent, to the detriment of consumers, the development of a market in which the licence is an indispensable input.

The doctrine of “essential facilities” combines discrimination, tying and refusal to deal. The suggestive label points to common application in sectors dominated by historic infrastructure monopolies, controlling facilities such as ports, wires, pipelines and airports. The logic – denying access to something that competitors need to provide their own product or service – invites a broader application. The courts have resisted invitations to extend the doctrine, though. The ECJ refused to find that newspaper distribution is an essential facility, reasoning that a competing newspaper could use the post or rely on newsstand sales.

Problems in network industries about access and strategic exclusion remain prominent in the Commission’s Article 82 caseload. The program for liberalisation of these sectors relies largely on indirect application, through sector-specific directives. Improvements in national regulation and market opening have not eliminated the need for direct enforcement actions, though. In 2003, the Commission fined Deutsche Telekom EUR 12.6 million for exclusionary pricing of local loop access, and it fined Wanadoo EUR 10.4 million for an exclusionary strategy in pricing ADSL. In these actions, the Commission pointed the way for further sector reform and presented a standard for cost assessment (EC DG Comp 2004).

Original case law doctrines about abuse of dominance rested on the concept of “distortion” of competition, from Article 3(g) of the Treaty. Thus the acquisition of a competitor could be a prohibited abuse because the dominant position distorted the market structure. A refusal to supply a competitor might be treated as adversely affecting the structure of the market by destroying the competitor’s capacity to compete effectively. The seminal *United Brands* decision focuses on how the dominant firm’s strategies limited the independence of smaller business, implying that coercion could demonstrate dominance regardless of actual effect on the competitive process. It also decried restraints that “limit markets to the prejudice of consumers”, implying appeal to a consumer-welfare standard as well. The early *Hoffman-LaRoche* and *Michelin* cases barred fidelity devices that pressured firms to deal with a dominant firm unless there was “economic equivalency” in the transactions and there was no significant effect on the structure of competition. The approach implied by these judicial authorities, concerned about preserving the positions of individual firms and competitors, no longer reflects the Commission’s own policy view.

A wide range of remedies is available to correct and deter abuse of dominance. The new enforcement regulation has authorised the Commission to order structural relief, which could include divestiture but might also include other dispositions of property rights. These measures must be proportionate. The Commission may only use structural measures to correct abuse of dominance where there is no equally effective behavioural remedy, or any behavioural remedy would be more burdensome to the entity that will be the object of the structural remedy. The new enforcement regulation also

confirmed that the Commission can order interim relief, which is particularly significant in cases about access. Behavioural orders and financial sanctions remain the principal tools. Substantial recent fines include EUR 13 million for exclusionary pricing in telecoms and EUR 24 million for loyalty rebates. The fine against Microsoft shows that Community sanctions against abuse of dominance can be vigorous; at EUR 497 million, it exceeds the total fines the Commission imposed against horizontal cartels in 2004.

Article 82 is one of the next subjects due for modernisation. The Commission plans to issue a discussion paper soon, which may be a prelude to proposed enforcement guidelines. The result will probably follow the pattern of other new guidelines, focusing on aspects of conduct that are related to competitive effects and economic principles more than on formal distinctions and classifications. A contribution to the discussion from the Economic Advisory Group for Competition Policy, posted on the DG Comp website in July 2005, advocates an economic approach based on the market effect of a practice, rather than its form or classification.

2.5. Mergers

The inclusive legal standard for merger control can deal with all kinds of competitive effects. The Commission may prevent or correct a merger that would “significantly impede effective competition ... in particular as a result of the creation or strengthening of a dominant position”. This substantive standard is subsidiary to the Regulation’s fundamental criterion, whether the transaction is “compatible with the common market”.²⁵ The 2004 revision of the Merger Regulation revised the original 1989 standard. The principal issue motivating the change was non-coordinated effects in oligopoly markets, where the merged firm might have market power without necessarily having an appreciably larger market share than the next competitor.

The Commission’s 2004 guidelines about horizontal mergers imply strong harmonisation in approach across the Atlantic, at least for horizontal combinations. The guidelines’ structural safe-harbours and presumptions are based on market shares and HHI. The guidelines presume that a merger does not impede effective competition if the new entity’s market share would not exceed 25%; however, this presumption does not apply to coordinated effects, where the merged entity would be collectively dominant along with other third parties. The guidelines rely on HHI levels not as firm cut-offs, but as points beyond which it is more, or less, likely that detailed analysis will be needed or that a competition issue will arise. With that general caveat, the guidelines draw the bottom line at post-merger HHI of 1 000. The line of greater scrutiny is drawn at post-merger HHI up to 2 000, changing by less than 250 points, or over 2 000, changing by less than 150 points. Regardless of these levels, though, the guidelines warn that special attention will be paid if

any party has a pre-merger share over 50%, or if there are obvious issues of potential or toe-hold entry, innovation, cross-shareholding, “maverick” market behaviour or indications of oligopoly behaviour in the industry. The guidelines discuss in detail the theories of non-coordinated and co-ordinated anti-competitive effect. Where non-coordinated effects are the concern, an important indicator where products are differentiated can be the closeness of substitution between the merging firms’ products, for homogeneous products, an important factor is the relative capacities of the merging firms and their rivals. A market share over 50% and a significant market share advantage over any rival may be a strong indication that the merger would create or strengthen a dominant position. Where co-ordinated effects are the concern, the guidelines describe the conditions for finding that a merger will create or strengthen a position of collective dominance.

Countervailing factors include buyer power and entry. Whether significant entry is likely is determined by inquiring whether an entrant would find it profitable to do so in post-acquisition market conditions. Entry must not only be likely but also sufficient and timely. The measure of timeliness could vary in different product markets, but the normal test is 2 years.

Efficiencies can also be a mitigating factor, if they are merger specific, timely, verifiable, and benefit consumers. Reductions in variable or marginal costs are more likely to lead to lower prices, and hence they would get more weight than savings in fixed costs. The guidelines disavow an efficiency “offence”, that is, that increases in productive efficiency, giving the merged firm a cost advantage over rivals, will be a reason to reject a merger.

If one of the parties is financially failing, the guidelines would permit an otherwise anti-competitive merger. The rationale is that the competitive structure would deteriorate equally absent the merger. The parties must show that the allegedly failing firm would in the near future be forced out of the market by financial difficulties if not taken over by another firm, that there is no less anti-competitive alternative acquirer, and that in the absence of a merger the assets of the failing firm would inevitably exit the market.

The merger regulation and the guidelines do not call for considering policies other than effects on competition. Efficiencies are taken into account as part of the competitive assessment. Although the Commission does not consider other policies explicitly, the merger regulation recognises that Member States may do so in defined circumstances. They may take “appropriate measures” to protect public security, media plurality and prudential financial rules, as long as those measures are compatible with Community law, concerning mergers that have a Community dimension. Member States could invoke these principles to block or regulate transactions that do not impede competition; however, they could not invoke them to authorise a transaction that the Commission has blocked.²⁶

A concentration cannot be put into effect before it is notified to the Commission and the Commission has cleared it. This merger control power applies only to transactions that are large enough to have a Community dimension. That status and the associated obligation to notify the Commission in advance are defined in terms of turnover, in total and within the Community. A transaction has a Community dimension when the combined aggregate worldwide annual turnover of all of the firms involved is more than EUR 5 billion, and the aggregate turnover within the EEA of each of (at least two) of them is more than EUR 250 million. An alternative definition captures certain transactions that have significant effects in several Member States. If the merging firms concentrate their Community business in a single Member State (with each of them having more than two-thirds of its Community turnover there), then the merger does not have Community dimension and the national competition authorities are responsible for it. There is also now a discretionary process for avoiding multiple national filings and reviews. If a merger may have to be reviewed in 3 or more Member States, the merging firms can request that the Commission examine the merger, which it will do if none of the Member States objects. Merger control is more like a formal approval than a simple notification. The merger regulation, the Commission's implementing regulation and its "best practice guidelines" set out the process. It begins with informal contacts with DG Comp staff, including submission of a briefing memorandum and draft notification documents, before any formal filing is made. The formal process begins with submission of a detailed notification describing the transaction, its motivations, markets affected, market shares, and conditions of supply, entry and exit, and considerable other documentation. The Commission may use all of its other powers to get further information from the merging parties and from others. The Commission's decision process for mergers is similar to the process for other competition matters, except that merger decisions are subject to strict deadlines. The deadlines are now set in terms of working days. In the "first phase", the issue is whether to clear the transaction or to open a second phase investigation; the deadline to finish the first phase is 25 days; if the matter continues to the "second phase" investigation and decision, the deadline is 90 days from the beginning of the second phase; if the parties offer modifications to deal with competition concerns, the first phase can be extended to 35 days, and the second phase, to 105 days.

Guidelines about the treatment of non-horizontal mergers, particularly vertical ones, may be issued in the future, once Court judgments have been taken in some important pending cases. The most prominent of these is the appeal of the Commission's decision against the conglomerate GE-Honeywell merger. The Commission is also engaged in a study of the effectiveness of merger remedies.

2.6. State aid

Basic principles for the control of state subsidies and other aids in order to prevent distortion of competition are contained in Articles 87-89 of the Treaty. The Commission determines whether aid violates the Treaty standard, and it can order the Member State to end it and order the recipient of illegal aid to return it. The Council can override the Commission's actions about state aid, in exceptional circumstances, but it must do so by unanimous vote. The policy motivation for state aid control in the original treaties was to prevent national favouritism and thus promote opportunities for trade and competition among the Member States. DG Competition administers the system for notification and approval and deals with state aid policy and decisions about most sectors. Other directorates-general apply the rules in transport, coal, agriculture and fisheries.

The substantive criterion is whether the aid distorts or threatens to distort competition by favouring some products or enterprises (and affects trade between Member States). Drawing on this text, the elements that define state aid are state resources, advantage to firms or industries, selectivity, distortion of competition and effect on trade. Correct classification has practical consequences. A measure that falls within the formal category "state aid" must be notified and approved by the Commission in advance. Thus the first issue to determine is whether a program or action constitutes aid. To then assess whether aid is compatible with the common market, the Treaty describes permissible purposes for aid. Aid is permitted for redressing underdevelopment and unemployment and for dealing with serious economic disturbances and important projects of common European interest. Aid for other regional development and for promoting culture and preserving heritage is permitted only where it does not adversely affect trading conditions to an extent contrary to the common interest. The Council may define other categories of aid that are compatible with the common market. Aid issues are classified into "horizontal", regional, fiscal and sectoral, as well as the special provisions about coal, transport, agriculture and fisheries. Recent cases have involved shipbuilding, motor vehicles, steel, telecoms and broadcasting. The Commission has issued several notices and guidelines clarifying its policies about aid for regional development, employment, research and development, environmental protection and corporate rescue and restructuring. Block exemption regulations define permissible aids for small and medium sized enterprises, training and employment. The process of applying the legal standards and regulations depends more on categorisation than on direct evaluation of actual or threatened distortions of competition in particular markets.

Aid that pays for provision of public services might conflict with the principle that state aid should not distort competition. The state aid rules

permit compensation for the performance of functions that the market could not be expected to provide, such as geographic coverage or universal access, but they do not permit over-compensation. The ECJ resolved a long-running controversy over how to balance these considerations in its 2003 *Altmark* judgment. The judgment announced criteria for determining that support does not confer a competitive advantage, and hence does not constitute aid that must be notified and approved in advance. These are: clear definition of the public service obligations in national law; objective and transparent parameters for compensation determined in advance; and compensation no greater than costs (including a reasonable profit). Most imaginatively, the court decided that the provider would have no competitive advantage, and therefore the compensation would not be aid, if it had been selected through open bidding or a public procurement process. If there is no competitive bidding process, the reference for costs will not be the actual cost of the provider, but those of a hypothetical, normally efficient and economically viable company.

In July 2005, the Commission issued a package of measures clarifying treatment of compensation for public services, building on the direction of the case law. One element of the package is a Commission decision that specifies conditions under which compensation for public services does not have to be notified in advance. The decision includes a quantitative threshold, being applicable to compensation of less than EUR 30 million per year provided the beneficiaries have annual turnover of less than EUR 100 million. Compensation to hospitals and social housing for services of general economic interest benefits from the decision irrespective of the amounts involved. Compensation for air and sea transport to islands and for airports and ports is covered by the decision below thresholds that are defined in terms of passenger volumes. Another element of the package is a framework document explaining the conditions under which compensation that does not meet the criteria of the decision, and hence must be notified and approved, would nonetheless be compatible with the state aid rules. In particular, compensation that exceeds the costs of the public service or that is used by the recipients in other markets that are open to competition would be incompatible. The package also includes an amendment to the directive about transparency, clarifying the obligation to maintain separate accounts to facilitate checking for over-compensation.

The Commission is focusing its attention on the kinds of aid that are most likely to distort competition. These are restructuring aid, regional aid targeted to large firms, fiscal aid to attract investment and aid sectors that are key to competitiveness such as newly liberalised services and network industries. In the traditional network industries, aid is often connected to controversies over responsibility for stranded costs. The Commission has undertaken an inquiry about new guidelines for state aid, following the

Council's March 2005 direction to Member States to work towards reducing the level of state aid while making allowance for market failures. The Council called for redeploying aid towards research and innovation and the optimisation of human capital, while reforming regional aid to encourage investment and reduce disparities. General rules will try to identify better the classes of likely market failure that can be traced to subsidy distortions. Application will examine whether the aid corrects the failure and whether it is done in a way that minimises distortions of competition. The system of notification and approval is likely to be retained, but the Commission's consultation notice also suggests that some oversight and enforcement responsibility could be shared with independent authorities in Member States.

2.7. *Unfair competition and consumer protection*

Claims about unfair competition between firms are matter of Member State national law. By contrast, consumer protection is recognised in the Treaty as a Community responsibility. Treaty Article 153 provides that "the Community shall contribute to protecting the health, safety and economic interests of consumers, as well as to promoting their right to information, education and to organise themselves in order to safeguard their interests". Community regulation about consumer protection is authorised to some extent, but principal reliance is placed on Member State laws. The Treaty permits Member States to adopt consumer protections that are more stringent than Community regulations in the area. The Treaty language implies a focus on product standards, including environmental and safety concerns.

Community consumer protection policy now also addresses market issues such as information asymmetry and bargaining fairness. A directive to harmonise Member States' rules on unfair commercial practices was signed in May 2005 and is expected to become effective in 2007. It clarifies consumers' rights by establishing common rules against aggressive or misleading marketing to consumers. It defines a limited range of "sharp practices" that are to be prohibited EU-wide. These include so-called "pressure selling", such as implying that a consumer cannot leave the shop without signing a contract, conducting personal visits to the consumer's home and ignoring the consumer's request to leave or not to return, and misleading marketing, such as bait-and-switch tactics, falsely claiming to adhere to a code of conduct or describing a product as "gratis", "free" or "without charge" if the consumer has to pay anything other than unavoidable delivery or collection costs. The directive also establishes general principles that can be used to assess whether other types of practices should be prohibited as unfair. The key test in most cases is whether the practice would unfairly distort the behaviour of an "average" consumer, although there are also provisions aimed at preventing exploitation of particularly vulnerable consumers. These norms will be enforced at the

national level. The lack of Community-wide consumer protection enforcement contrasts with the Commission's powers to apply competition policy directly.

To make the connection between competition and consumer interests more visible, DG Comp has designated a Consumer Liaison Officer to develop contacts with consumer NGOs, soliciting complaints about infringements and comments on policy proposals. The post will also improve communications with other Commission Directorates General, especially Health and Consumer Protection.

Norms about fair dealing and relative bargaining power between businesses, such as rules against sales below cost and abuse of economic dependence, are not part of Community law. They are, however, included in the laws in several Member countries, and sometimes in their competition laws. These laws related to unfair competition can be inconsistent with a consumer-welfare conception of competition policy. Under the Community enforcement regulation, Member State laws about the unilateral conduct of dominant firms can be stricter than Community law. This concession to local variation permits these national regimes to control abuses of economic dependence in conditions where dominance of an economic market is not an issue.

3. Institutional issues: enforcement structure and practices

The administrative process for applying the law is adapting to strengthen investigative powers and better incorporate economic concepts and evidence in decision-making, in order to convince the courts while maintaining policy consistency in a system of decentralised enforcement.

3.1. Competition policy institutions

The European Commission, as the Community's executive body, implements its competition policy. By Treaty, the Commissioners shall, "in the general interest of the Community, be completely independent in the performance of their duties", neither seeking nor taking instructions from a government or anyone else, and refraining from any action incompatible with their duties. Member governments undertake to respect the principle and not to seek to influence members. The Commissioners have protected tenure during their 5 year terms. Only an order from the ECJ can remove a Commissioner. Still, the Commission's structure and appointment process embody indirect links to the Member governments and to the Community's political institutions. There are 25 Commissioners, one from each Member State. When a Commission is created, the Member State governments first agree on a nominee for Commission President. Once approved by Parliament, the president-elect then nominates the other Members of the Commission, in

accordance with proposals made by each Member State. The president-elect's nominees are then appointed by the Council, after approval by Parliament. The nominees tend to be politically experienced, often with previous service as government ministers.

Decisions about policy initiatives and cases are taken by the Commission as a body, which meets weekly (but which can also act by written procedure or delegated authority). As a practical matter, competition policy is dominated by the Commissioner holding the competition portfolio. The Commission has not disagreed with the Competition Commissioner's recommendation on a major enforcement matter since some merger decisions in the early 1990s. More recently, deliberation among the Commissioners did lead to adjustments in some state aid matters and the motor vehicle block exemption regulation. But on balance, the *de facto* prerogative of the Commissioner for Competition has increased. With that increased prerogative has come increased confidence that Commission decisions about important competition cases are made independently of other policy considerations and influences.²⁷

In the Commission staff, the Directorate-General for Competition is principally responsible for competition policy and enforcement. Headed by a Director General who is a career Community manager, DG Comp is organised into 10 directorates, for management, antitrust and merger policy, cartel enforcement, sectoral expertise (4 directorates) and state aid (3 directorates, including one for policy). DG Comp's complement has been stable for several years at just over 600 permanent staff. In addition, DG Comp relies on contract and auxiliary personnel and experts seconded from Member State competition agencies.

3.2. Enforcement processes and powers

The Commission uses broadly similar basic procedures and investigative tools for dealing *ex post* with infringements²⁸ of Articles 81 and 82 and for decisions about notified mergers. A complaint or merger notification, or a decision to start a procedure at the Commission's own initiative, is followed by an investigation by DG Comp, managed by a case handler. The evidence and proposed remedy are presented to the respondent in a "statement of objections". The respondent has a right of access to the investigative file and an opportunity to reply, in writing and at an oral hearing. The decision is taken by the Commission, on a recommendation of the Competition Commissioner. The Commission no longer processes applications for individual exemption or negative clearance, because it no longer has the power to issue them. The enforcement regulation provides for the possibility of a "guidance letter", but it sets conditions to discourage routine requests. Now that the historically important system of notification and exemption has been eliminated, the legal criteria describing what is prohibited and what qualifies for exemption

apply directly. In effect, this approach puts a burden on companies to evaluate their agreements accurately, as they are at risk for making a mistake.²⁹

A complaint is submitted on a prescribed form. Comprehensive background information and documentation are required. The complainant is asked to detail the factual basis of the claim, supply information about markets and market shares, submit documents and statistics relating to the complaint, give names of persons who could testify about it, explain the complainant's legitimate interest in the matter and specify the relief sought.

Investigative tools and powers deal principally with documentary information, since Commission procedures rely heavily on documentary evidence. A request for information may be a "simple" request or a "request by decision". Each will state the basis and purpose of the request, specify the information requested and the deadline, and indicate the consequences of incorrect or misleading response. There is no penalty for failing to respond to a simple request, although a company can be fined if its responses are false or misleading; by contrast, a company risks substantial fines for failure to respond to a request by decision. It is no longer necessary for the Commission to send a simple request before sending a request by decision.

To get information that companies are likely to want to conceal, the Commission can launch a "dawn raid". It has the power to enter business premises (and vehicles), to examine physical records and take copies and extracts. It can seal the premises during the search and ask representatives for explanations of what it is finding. The Commission can require responses about factual matters, but not statements that admit an infringement. The company can have its lawyer present, but cannot delay the process too long in order to summon counsel. In antitrust matters, but not merger investigations, the "dawn raid" power extends to homes of individual directors, managers and staff, on reasonable suspicion that books and records about the business and the subject of the investigation are there. If a firm resists co-operating, the use of force to obtain entry requires an order from a national court. The Commission must describe the nature of the suspected infringement and the target's involvement in it and explain the need for the particular search. The national court can verify that coercive measures are not arbitrary or disproportionate; however, the court may not demand to see the evidence in the Commission's file. The power to search residences has not yet been used as of mid-2005.

Testimony has been relatively unimportant. In the past, it has usually been confined to answers to factual questions about documents asked during a dawn raid and statements made at an oral hearing after the Commission has issued a statement of objections. The Commission now has a limited additional power to interview persons during investigations. But the individuals must

consent to the process, and they face no penalty if the information they provide is false or misleading. Leniency applicants, who are under a duty of co-operation, are more constrained to tell the truth than the subjects of these interviews will be. As of mid-2005, the new interview power had only been used in cartel investigations.

Providing false or misleading information in an investigation, or failing to provide complete and accurate responses within the time set by a request by decision, may result in fines of to 1% of turnover. Daily periodic penalties of up to 5% of average daily turnover may also be imposed to compel complete and accurate responses to a request by decision. Usually, those penalties would accrue only if the recipient fails to respond on time. In a merger proceeding, recalcitrance that requires the Commission to resort to a request by decision can toll the decision deadline.

The Competition Commissioner decides about whether to send a statement of objections, after consultation with the Commission's Legal Service, an external unit that reports to the President of the Commission. The parties have a right to access the Commission's file after the Commission has issued the statement of objections. The statement of objections is not usually the first contact between the Commission staff and the respondent about the theory of the possible case, though. A pattern of "best practices" about the exchange of views and evidence has developed over the years. For merger matters, DG Comp has set out these "best practices" in a publication, in which DG Comp commits to make its best efforts to provide notifying parties with access to key documents such as third-party submissions once the second phase begins. They also provide for "clear the air" meetings between merging parties and third parties and regular "state of play" meetings between merging parties, senior DG Comp officials and the investigating team.

The oral hearing is conducted by a Hearing Officer. Most parties now take advantage of this opportunity.³⁰ There are now 2 Hearing Officers, who report to the Competition Commissioner but are not part of the Competition Directorate. In addition to ensuring the parties' right to be heard, they rule about confidentiality and other process issues. Their role and status was strengthened by a 2001 Commission Regulation stressing the need for independent oversight of competition proceedings. Their independence is ensured mostly by transparency about their appointment and termination, rather than by protected tenure. The hearing is not before the Commission or the Competition Commissioner. Those in attendance are usually the respondents, investigating staff, staff from other directorates of DG Comp, and staff from other Commission services and from Member State enforcement agencies.

"Scrutiny" or "peer review" panels are an important innovation in the internal process at DG Comp. These *ad hoc* committees are assigned to review

a matter and report about it directly to the Director-General. This process for internal quality control was set up in 2003, but it is not entirely new. Similar reviews had been done on a few occasions since the early 1990s. Panels are used about 10-12 times per year for cases that raise complex or novel issues. About 60% of the reviews to date have dealt with second-phase merger investigations, and about 30% with antitrust cases. The Director General designates each panel, which normally includes one head of unit, one senior case handler and one junior case handler. The review is organised by an official from the DG Comp policy directorate, who serves as “scrutiny officer” and writes the report for the Director General. The session at which the case team makes its presentation to the panel may last a full day. The Commission Legal Service, the Hearing Officer and other interested services may attend. Panels have suggested changes in more than half of the cases they have reviewed, mostly about remedies. In at least one case, a review of a merger resulted in dropping the case completely. Most peer reviews are held after the parties have replied to the statement of objections, so the panel can consider both the staff’s case and the strength of the parties’ response to it. A review may be held at an earlier stage, before the statement of objections is sent, to try out a potentially innovative theory.

Advisory Committees composed of officials from Member State competition agencies play a role in both antitrust and merger matters. These committees meet regularly and submit opinions about proposed decisions. Their opinions about mergers are appended to the decision and published. Their opinions about other cases are appended to the decisions and may be published if the Committee recommends it. Advisory Committee views do not control DG Comp’s recommendation to the Commission. But the consultation process is a valuable avenue for achieving general consensus, and DG Comp takes the views seriously.

The draft decision is prepared by the DG Comp case-handler (or team of case-handlers) and reviewed by DG Comp management. It is also reviewed by the decision scrutiny unit. The Competition Commissioner consults with the Legal Service and the Advisory Committee from the Member States before proposing a decision to the Commission. There are several other means for providing a measure of quality control over the staff’s recommendation, in addition to the possibility of an internal scrutiny panel. The Hearing Officer prepares a report about procedural issues, which goes to the Advisory Committee, and a separate report to the Director General assessing the response to the staff’s case. Although the Hearing Officer’s principal role is about issues of process, the reports may include insights about the evidence and the substantive issues. The Chief Competition Economist reports independently to the Director General and the Competition Commissioner. With the agreement of the Director General, the Chief Competition Economist could submit his advice to the Commission itself in

a separate opinion. The proposed decision is adopted by majority vote of the Commission members, although non-controversial matters can be decided without formal deliberation.³¹

The principal sanction for substantive infringements, set out in the Council regulation on enforcement, is an administrative fine against the infringing undertaking. This fine can be as high as 10% of the undertaking's global annual turnover. The regulation does not authorise fines against individuals. A Commission guideline explains the considerations applied in setting fines for infringements of Article 81 and Article 82. The process begins with a basic amount, which is then adjusted upwards for aggravating circumstances and downwards for attenuating circumstances.³² The basic amount depends on the gravity of the infringement (which includes its nature and impact (if measurable) and the size of the market) and its duration. The guideline recognises three classifications in terms of the gravity of the infringement: minor, calling for a fine between EUR 1 000 and EUR 1 million; serious, up to EUR 20 million; and very serious, over EUR 20 million. These approximate levels are not fixed. That amount can then be increased to account for duration, up to 50% for medium duration infringements and up to 10% per year for longer ones. The aggravating circumstances could include repeat offences, refusal to co-operate, leadership in the violation, retaliation against other firms and the need to set the penalty greater than the gain. The attenuating circumstances could include with a passive role in the violation, non-implementation, termination upon Commission intervention, reasonable doubt about whether the conduct was an infringement, negligence and co-operation with the Commission (outside of the leniency programme). The enforcement regulation now makes clear that the Commission can accept binding commitments to correct infringements and that the Commission can impose a fine for failure to comply with these commitments; however, commitments are not to be accepted in cases where the Commission intended to impose a fine in the first place.

The power of the courts to review the amount and appropriateness of a fine is unlimited. The courts do not require the Commission to follow a prescribed formula, recognising that an element of discretion is needed to tune sanctions to effective deterrence. But in law, the courts can reach their own decisions about the reasonableness of fines. Because of how fines are determined, this means the courts could effectively substitute their own opinions for the Commission's about the gravity and duration of the infringement. Decisions have paid close attention to how the Commission's computation conforms to the relevant criteria of aggravation and attenuation, if not to the choice of the starting point (Joshua, 2004).

The Commission has had a formal leniency program since 1996. After revisions to the program's terms in 2002, which replaced the "decisive

evidence” requirement and the “ringleader” proviso, the process is more certain and transparent. The first undertaking that comes forward can receive full immunity from fines. The evidence it supplies should be enough for the Commission to order an inspection. The application may be hypothetical; actual evidence can be supplied in a second stage. Conditional immunity can be granted within weeks, providing applicants with some legal certainty at an early stage. Even after the Commission has launched an inspection, immunity may still be possible if immunity has not already been granted to another. If immunity has already been granted, or if the Commission already has enough evidence to find an infringement, reductions of fines remain possible for companies that provide significant added value to the Commission’s case. For the second firm to come in, the fine could be reduced by 30-50%,³³ for the third, 20-30%; for others, no more than 20%. There are conditions: the applicant must co-operate throughout the Commission’s proceeding and end its involvement in the cartel, and it may not have coerced others to participate in the violation. Applications continue to increase. There were 16 in 2003 and 29 in 2004.³⁴

There have been controversies about whether corporate statements that leniency applicants provide to the Commission are discoverable in private civil suits. This concern has been raised in particular with respect to US treble damage civil suits. The Commission considers that a corporate statement, in which the company describes its participation in a cartel with effects in the EU, and which has been produced for the sole purpose of applying for immunity or a reduction of fines under the Commission’s leniency programme, should not be discoverable for use in other legal proceedings. While the Commission does not want to hinder civil litigation, it does not believe that plaintiffs in civil litigation should benefit from the unrelated and autonomous procedure of the Commission’s leniency programme, undermining that programme in the process. Against this background and to reduce the risk that confidentiality of such statements will be compromised, the Commission will depart from standard Commission practice, which depends strongly on written evidence. The Commission has already processed a large number of leniency applications on the basis of oral statements rather than written corporate statements. The Commission investigators record the applicant’s oral statement on a tape and will use the tape as evidence in its decisions and in proceedings before the EC Courts. The tape is treated as non-discoverable.

3.3. Judicial review

Commission decisions are subject to oversight by the two European courts. The ECJ, which was established in the original ECSC, ensures enforcement against Member States, decides disputes between the Community and Member States (and between Community institutions) and

ensures uniform interpretation of Community law by deciding questions referred to it by national courts. The CFI was created to reduce the ECJ workload and backlog by dealing with the cases with no political or constitutional importance and those involving complex facts. The ECJ can review CFI judgments, but only on matters of law. The possibility of a substantive appeal to the courts brings the Community's competition enforcement system into compliance with the European Convention on Human Rights. The ECJ held in 1980 that the Commission process did not provide the "independent and impartial tribunal" that the Convention requires.

The decision of the Commission in an infringement matter, to terminate the violation or pay a fine, is binding. The parties can bring an action in the CFI to annul it, on grounds of fact or law. Filing the court action does not itself suspend the application of the decision. The parties can request that the CFI suspend application pending the appeal. For fines, the Commission's practice is to agree to suspend pending appeal, on condition of providing a bank guarantee for the fine plus interest. If the courts annul a merger decision, that action does not amount to clearance; rather, the matter is sent back to the Commission to re-examine the notification, potentially repeating the two-phase merger review process. The judicial process has normally taken 2-3 years to complete. The CFI adopted an expedited process, providing for written procedures and a full hearing, through which it can complete a matter within 8-10 months after a Commission decision. Thus there is now a realistic prospect of judicial oversight of time-sensitive matters such as mergers. Rules about standing are generous, so complainants are regarded as individually concerned and hence can challenge the Commission's action or inaction.

The scope of review under the general Treaty provision looks limited and supervisory, not involving re-examination on the merits (Article 230). The grounds for judicial review are lack of competence, infringement of an essential procedural requirement, the Treaty itself or a rule of law related to its application and misuse of power. Despite this apparently narrow scope, the CFI and the ECJ have also overturned Commission decisions for inadequacy of evidence or error of fact. The courts have devised a category of "comprehensive review", and when applying it the CFI will control the accuracy and quality of the Commission's reasoning about economic and market analysis. The court rules provide for commissioning independent expert reports. In its 1985 *Wood Pulp* judgment, the ECJ relied on reports of its appointed experts to overturn the Commission's findings and conclusions.³⁵ The CFI at first rejected about half of the Commission's decisions imposing substantial fines; however, those actions may have represented an effort to set ground rules about procedures, since several of the rejected fines were later upheld after the Commission revisited the matters to correct the procedural flaws (Wils, 2004).

3.4. Other means of applying EU competition law

Private parties can sue in national courts, under national procedures, for relief from infringements of Community competition law. Such actions in national courts could have attractions, such as co-ordination with related claims about breach of contract or unfair competition. In general, remedies for infringement of obligations under Community law are determined by national legal systems and procedures, subject to a requirement of non-discrimination and efficacy. The claimant under Community law must not be worse off than a claimant under national law. Sometimes the Community law claimant can even do better, as the ECJ requires national courts to make remedies available in some situations even where national law does not (Hartley, 1994). State aid principles are also enforceable by private parties in national courts, that is, the disadvantaged competitor can obtain a judicial declaration and order that non-notified aid is illegal and thus must be repaid.

The practical incentive to file a private action was dampened by the available alternative of a cost-free complaint to the Commission, which for years acted as though it were under an obligation to give complaints priority treatment. The usual Commission infringement proceeding has elements of privately-initiated litigation. An advantage of taking the trouble to meet the demands of a formal complaint at the Commission is that complainant gains party standing, including the right to participate to some extent in the proceedings at the Commission and to seek judicial review if the action is unfavourable.

The Commission has long tried to encourage resort to private suits in national courts. In 1992, the CFI freed the Commission of the obligation to give complaints priority treatment, permitting it to defer to a national court to deal with a matter that did not have enough Community interest. Taking immediate advantage of the CFI's endorsement of its right to set enforcement priorities, the Commission issued a notice on co-operation with national courts to call attention to the option and provide guidance. Notably, national judiciaries must make available to claimants under Community competition law all remedies and procedures, such as injunctions and compensation, that are available to claimants under analogous or related national laws. But the Commission's monopoly on granting exemptions under Article 81(3) remained a disincentive until 2004. DG Comp is again trying to promote more private enforcement, to empower those who are the object of infringements of the law. Stronger private relief, providing complainants with a credible alternative avenue, is conceptually a correlate, or even a precondition, for the Commission's greater discretion over its own priorities and case selection. Procedures and powers of Member State legal systems must be taken into account, and judges need to be knowledgeable about competition issues. To

meet this challenge of decentralised enforcement generally, the Commission and others are supporting efforts by associations of national judges to organise seminars and programs about competition law and enforcement.

National courts are making more use of provisions permitting them to ask the Commission for information and opinions. The Commission has promised to respond quickly, within 1 month for information and 4 months for an opinion. The Commission's ultimate recourse if national courts appear to be taking inconsistent positions about a practice in an industry would be to take a decision itself. DG Comp has not usually made *amicus* appearances in national matters, but that is also an option that might be considered.

Member State competition agencies and courts can apply Community substantive law.³⁶ All Member States have taken the necessary national legislative steps to be sure that national institutions have the power to apply Community law. Indeed, national authorities now have an obligation to apply Community law if the jurisdictional requirement of Community effect is met. National authorities can, under Community law, order cessation of an infringement, order interim measures, accept commitments, impose fines and make negative determinations that there are no grounds for action. In a few countries, such as Ireland, the "national authorities" designated under the Community enforcement co-operation system include courts. Co-operation is encouraged and to some extent required. National authorities must notify the Commission 30 days before adopting an infringement decision, accepting a commitment or withdrawing the benefit of a block exemption regulation. The Commission can take over a case if, after consultation, it appears that the national authority might produce a result in conflict with established principles of Community law or that this is necessary in order to ensure efficient enforcement or to develop Community competition policy. Confidential information can be exchanged for purposes of Community law enforcement or simultaneous Community-national law action; however, confidential information from Community cases cannot be used directly in national law cases that threaten individual penal sanctions, except in the so-far unusual situation where the source and recipient countries have similar sanctions. A national authority can suspend or decline to pursue its own action if another authority is already dealing with the same conduct. This is optional, not mandatory. National authorities must assist the Commission's investigations, obtaining court orders if needed for dawn raids. National authorities may now carry out investigations in aid of the Community-law actions of other national authorities.

The informal "European Competition Network" (ECN) is the medium for facilitating inter-agency co-ordination. The ECN is conceptually and functionally distinct from the Advisory Committee that must be consulted about Commission enforcement proposals. It is also distinct from the

association of European national competition agencies, which has been in existence for several years (and which includes agencies in countries that are not Member States of the EU). The basis for the ECN is in the enforcement regulation requirements for consultation and provisions about information exchange and case allocation. The network is mentioned in the recitals of the enforcement regulation, but the ECN has no legal status. The notice on co-operation explains how it will work, to allocate cases, handle information and ensure consistency. A joint declaration in the modernisation package describes the agencies' non-binding expectations about co-operation. Normally, a case would be handled by the authority of the Member State that is most affected, and others would stay their own proceedings. The Commission would normally deal with matters that substantially affect more than 3 Members or where its intervention is appropriate in order to ensure efficient enforcement or to set policy. Where a national authority is already acting on a case, the Commission would only exercise its power to take over if it looks like it will be in conflict with others or with established Community case law, if it is taking too long, or if similar problems are appearing widely and a Community decision is needed to clarify Community policy. The Commission would not normally adopt a decision in conflict with a national authority's decision if it has been kept fully informed about the case. The ECN is also a forum for informal co-operation. The members hold occasional plenary meetings at the policy level. There are also working groups on topics such as leniency, transitional issues, sanctions and procedures, and Article 82, and sector subgroups about railways, electricity and insurance.

As agencies across the Community share enforcement responsibilities, complications will arise about parallel investigations and leniency applications in several jurisdictions. Exchange of experiences has led to the introduction of generally consistent leniency programs in the Member States. Programs are in place in 17 Members now, and programs are planned in several more. Enforcement could suffer if multiplicity and inconsistency deter firms from coming forward. Differences among the programs are few, mostly about the obligation to stop the infringing conduct. Some permit continuation to avoid tipping off other conspirators so they will destroy evidence. Although the absence of programs in a few Members may cause firms some anxiety about the risk of exposure, the network notice requirement provides some safeguard. Information given by a leniency applicant can only be exchanged with other enforcement bodies with the applicant's consent, except if it has also applied with the receiving authority or if the receiving authority promises in writing not to use it or any information collected after the date of transmission to impose a sanction on the applicant. This permits *de facto* export of leniency to countries without programs. Multiple filing is consistent with parallel competences, but demanding complete applications everywhere

imposes some practical burden. To ease the burden, a few national authorities are accepting “short form” leniency applications. One potential complication arises from the fact that several Member States provide for criminal penalties. In Ireland and the UK, the national leniency programs deal with the eligibility of individuals. This is less clear in other Member States that provide for criminal liability, at least for some anticompetitive conduct. These include Austria, Belgium, France, Germany, Greece and Spain.

The merger regulation also provides for co-ordination among the agencies. The system of allocating jurisdiction provides the possibility that, with the agreement of the Member State agencies, the Commission can review mergers that do not have a community dimension but that would need to be notified in a large number of Member States. The system provides for consultation about such transactions before they are notified. In the first year, there were 30 requests for clearance to DG Comp because of multiple coverage, obviating 214 national-level multiple notifications. This amounted to about 10% of the cases under the new regulation. On a few occasions, company requests to have their mergers reviewed by the Commission were vetoed by Member States that wanted to review the mergers themselves.

3.5. International issues

Community institutions have not usually claimed jurisdiction on the grounds that conduct outside the Community has had an effect within it. Instead, other legal constructions are applied so that conduct outside the Community that is a matter of concern to Community enforcement can be characterised as having taken place within the Community. One such device is the group economic unit. If a parent outside the Community could control an affiliate or subsidiary within it, that power will support an imputation that the foreign parent has acted within the Community. This imputation does not require proof that the parent has actually done so. Another tool is the conception of the implementation of a practice. If a cartel sells something to a customer in the Community, the agreement is said to be implemented there even if the sale is direct and no member or affiliate is actually found within the Community territory. ECJ judgments supporting these legal constructions have declined to apply the arguments of the Commission and the Advocates General of the ECJ in favour of the simpler, more direct doctrine of jurisdiction based on effect in the Community. But at least for mergers, cases such as *Gencor* and statements in speeches by enforcement officials imply acceptance of the emerging international law norm of an effects-based approach, at least where effects are immediate, substantial and foreseeable (Goyder, 2003).

The Commission has formal co-operation agreements in competition matters with the Canada, Japan and the United States. The agreement with the United States provides for notification of cases that concern the important

interests of the other party, exchange of information on general matters, co-operation and co-ordination, traditional comity and positive comity, that is, providing for a request that the other party take action under its legislation concerning behaviour affecting the important interests of the requesting party.³⁷ These arrangements have fostered a near-continuous co-ordination in merger and cartel cases, notably to deal with simultaneous leniency applications. Formal notifications from one to the other occur nearly once a week in each direction. The Commission cooperates on a bilateral basis with numerous other competition authorities. Relationships have been particularly continuous with Australia, China, Korea, Mexico, Brazil and EFTA countries. Cooperation with OECD Members is carried out on the basis of the 1995 OECD recommendation. With Korea, the Commission has established a permanent forum of consultation, transparency and cooperation on competition. The Commission has also initiated with China structured dialogue to exchange experiences and views on competition matters. With certain Latin American and Mediterranean area countries, the EU has free trade agreements, which usually contain basic provisions concerning cooperation in competition matters. The Commission has particularly close cooperation, including exchange of confidential information, with the EFTA Surveillance Authority in enforcing the competition provisions in the Agreement on the European Economic Area (EEA Agreement). Information exchanged between the Commission and the EFTA Surveillance Authority may be forwarded to the competition authorities in the Member States and the EFTA countries. Recognising the importance and opportunity for close co-ordination of large-scale cartel investigations, the Commissioner has supported moving toward a “second generation” agreement allowing the exchange of legally protected information with the US enforcers (Kroes, 2005).

3.6. Resources and priorities

DG Competition is one of the largest competition agencies in the world, with about 615 permanent staff.³⁸ About a quarter of them deal with state aid (167 work years in 2005), and about half with antitrust, mergers and liberalisation (375). In addition to the permanent staff positions, the competition mission relies on about 67 auxiliary and contract agents, many of them in support positions, and about 41 experts seconded from national enforcement agencies. The competition directorate has long been considered understaffed. One reason given for shifting more cases to national agencies was the fear that resources in DG Comp were “clearly inadequate” for law enforcement in the Community (Goyder, 2003, p. 531). Staff levels have increased since the 1990s. In 1999, the total complement of permanent staff was 486. In the context of decentralisation, the resources available now for Community law enforcement are substantial. Taken together, the competition agencies in the EEA area have nearly 3 300 staff.

DG Comp is organised into directorates that specialise by enforcement function and some that concentrate on sectors. Creation of sectoral directorates and units is intended to improve the capacity to respond to matters that arise under different legal theories, by reducing the need to re-establish basic factual foundations. The special merger task force has been disbanded. Its capacity is now distributed among the mergers units in each of the 4 sectoral directorates. In June 2005 a new directorate specialising in cartels was established. After the dismantling of the merger taskforce, this is the only directorate in DG COMP devoted to a particular enforcement function. Specialisation on this subject is motivated by the importance in these cases of investigative methods and legal issues such as the rights of defence. Thus, this directorate's staff of about 40-50 is dominated by lawyers and other experts, such as accountants, who work regularly with legal issues. It does not have a monopoly on cartel cases, though. The sectoral enforcement divisions may have a comparative advantage in detecting cartel behaviour, because of their continuing contacts within industries. State aid occupies 3 directorates, one of them for policy and co-ordination, one for network industries and liberalised sectors and one for regional, restructuring, research and development and environment and energy aids.

As economics is playing a larger role in Community competition policy, the proportion of economists on the DG Comp staff has increased. The number of permanent DG Comp staff whose training is in economics (173) is still somewhat lower than the number whose training is in law (202). But ten years ago, lawyers reportedly outnumbered economists 7 to 1 (Wilks and McGowan, 1996). To raise the profile of economic analysis, a separate economic unit was created in 2003. The new Chief Competition Economist reports directly to the Director General. He is supported by about 10 experts, all with doctorates in industrial organisation economics, who work with the staff of the enforcement and policy directorates. The Chief Competition Economist and half of the members of this unit come from outside the Commission. They are serving in DG Comp on temporary contracts. Case support occupies about 7 members of the unit. The unit is called on for most Article 82 cases and second-phase merger investigations, and occasionally for Article 81 cases. The unit also contributes to policy studies. The Economic Advisory Group for Competition Policy (EAGCP), composed of academic economists nominated by the Chief Competition Economist and appointed by the Commissioner, is another source of expertise and advice about policy for DG Comp and the Commissioner. EAGCP sub-groups about antitrust, mergers and state-aid may present an opinion at the request of the Chief Competition Economist, the Director General or the Commissioner, and its members may also be asked for advice on an ad-hoc basis.

The Commission has adopted as one of its primary objectives to re-invigorate the 2000 Lisbon agenda, to improve European innovation and competitiveness. Highlighting this commitment, the Competition Commissioner launched a series of inquiries into competition problems in some critical sectors that should be counted on to make contributions to European competitiveness. These inquiries will examine conditions and recommend measures for enforcement or regulatory reform in financial services (retail banking and business insurance), electricity and gas. About 8-9 professionals are assigned to work on each inquiry, along with their other duties. The first reports from these inquiries are expected in late 2005, and steps toward implementation will follow in 2006. The 2005 Annual Management Plan for DG Comp, implementing its part of the Commission's overall program, focuses on cartel enforcement, key sectors such as those subject to recent liberalisation and advocacy. To address these priorities, some staff have been shifted to the sector inquiries and the cartel division.

Changes in methods and adoption of different priorities have changed the nature of the caseload. With the end of the notification system, the number of individual cases has declined sharply. Indeed, even the number of matters initiated by complaint or by the Commission itself has declined. In 2004, the Commission reports that it opened 52 antitrust matters on its own initiative, compared to an annual average of about 85 over the previous 5 years. Another 85 antitrust matters were opened based on complaints; this compares to a previous average of 120. The number of formal Commission antitrust decisions is also declining, from 68 in 1999 to 24 in 2004 (European Commission, 2005, pp. 56-57). This general decline in the number of competition law proceedings may be the result of choosing not to pursue minor cases. The Commission tries to concentrate on cartels and foreclosure. There are few infringement matters involving vertical agreements, except for clear territorial restrictions or cumulative foreclosures. The merger caseload in 2004, which saw 242 decisions, was down from the peak of 345 in 2000, but up slightly from 231 in 2003 (European Commission 2005, p. 96).

The Annual Management Plan lists DG Comp's current plans and priorities. Of particular note are planned investigations into abuses of dominance in information industries and the pharmaceutical and chemical sectors, and investigations of other anti-competitive behaviour in pharmaceuticals, mobile telecommunications, media markets, copyright licensing societies, rough diamonds and automobile distribution and repair. Other sectors or industries mentioned for attention, many of them under the liberalisation agenda, include natural gas, electric power, high-speed internet access, postal service operators in non-reserved markets, air transport alliances, possible cartels in banking and barriers to cross-border competition in securities trading.

4. Limits of competition policy: exclusions and sectoral regimes

There is no general principle in the Treaties or in Community jurisprudence about how to deal with a conflict between the demands of competition law and those of other Community-level laws or official actions. Many passages in the Treaty that promote other policies and goals include provisos to ensure consistency with the goals of open markets and free competition. If a conflict arose, the legal argument could be over whether the conflicting decision or regulation was illegal because its derogation of competition was not supported by Treaty authorisation to do so. The omission of such a proviso in other passages might imply greater leeway about those topics in the event of conflict.

Conflicts with Member States laws and official actions have been a much more important topic. The Member States' capacity to use national law to prevent or restrain competition is limited. A Member State may constrain the freedom to set prices, if this is manifestly an exercise of government authority and not rubber-stamping of a private agreement and if the power has not been removed by Community legislation. But business firms cannot usually defend their infringements of Article 81 or Article 82 by claiming that national regulation eliminated their freedom of competitive action. This argument only succeeded once, in the *Sugar Cartel* case in 1975. Many cases in the 1980s confronted such purported defences in the context of government-tolerated cartels arranged through traditional trade-associations, where the government order obviously followed the industry's own initiative. Some cases from the 1990s appear to have tolerated pricing agreements, though, where the bodies that reached them, before seeking government imprimatur, comprised mostly non-industry, public members and were required by statute to act in the interests of all market participants, and the state retained the power to reject the proposal. The CFI's 2003 *Greek Ferries* judgment confirms that public authority recommendations may not insulate firms from liability for price fixing, at least as long as the public authorities' pressure was not binding or irresistible.

Member States may adopt rules that constrain competition in order to promote some sectoral or other policy, as long as there was no contrary Community policy on the issue and other Treaty obligations are respected. Since those other Treaty obligations include market openness and non-discrimination, national measures that might affect trade would not be permitted. But the Treaty texts combine to disfavour a broad "state-action" exemption. Article 10 of the Treaty obliges Member States to take all appropriate measures to fulfil their obligations and to facilitate the Commission's task, and it requires that they abstain from any measures that could jeopardise attainment of Treaty objectives. One of those objectives is "a system ensuring that competition in the internal market is not distorted" (Article 3(1)(g)). Thus the

Members are obliged to support, and not to undermine, Community competition policy goals. Member State institutions are under a Treaty obligation not to apply such national laws, and hence private undertakings cannot use national legislation that fails this standard to protect themselves from liability under Community law. The Member States themselves might be held liable for breaching Article 10 if national legislative or administrative measures render ineffective the Community competition rules applied to undertakings.

Close questions about conflicting claims have arisen concerning culture and professional services. The ECJ has rejected the claim that resale price maintenance for books was necessary to protect specialist book shops and the printed media against reduction in variety and availability. The court emphasised that curbing competition about imports would violate the Treaty's market-opening obligation. But the ECJ's 2002 *Wouters* judgment defers to other policy claims, holding that an agreement to limit competition among professionals was actually, when taken in context, an agreement to assure integrity and experience to consumers and to the administration of justice. As such, the agreement was not even covered by the prohibition of Article 81(1). The court ignored the suggestion of the advocate general that the policy conflict should be resolved by treating the legal profession as providers of services of general interest under Article 86.

Article 86 is, along with the rules on state aid, the principal Treaty tool for control of government measures that restrict competition. It is also a key instrument for opening up previously monopolised markets to competition. It deals specifically with public firms, firms with special and exclusive rights services of general interest and revenue-producing monopolies authorised by law. In general, Member States may not enact or maintain any measure contrary to the Treaty rules about competition and trade concerning public undertakings and those that have been granted special and exclusive rights. Article 86 mentions specifically the competition rules of Articles 81-89 and Article 12, forbidding discriminations based on national origin. There is an exception from the Article 86 prohibition. Measures that would otherwise be in violation of Treaty rules are permitted if applying the Treaty rules would obstruct performance of the particular service of general economic interest that has been assigned to an undertaking, and entrusting the undertaking with that task does not affect the development of trade "contrary to the interests of the Community". The exemption has been construed narrowly, to cover only activities with a direct relationship to the entity's main, permitted statutory function, and only where there is a prospect of inherent conflict between that entrusted task and the Treaty rules at issue. It is not enough that the function is economically important. Government measures must have actively and deliberately entrusted the function to the entity.

The Commission's 2001 Communication on Services of General Economic Interest provides some guidance about its intended interpretation of Article 86. States are free to define what counts as a service of general economic interest. The Commission does demand, though, that the public service mission be clearly defined and explicitly entrusted through an act of public authority. This could be a contract, rather than legislation. A designation of an ostensibly general interest service could be rejected on grounds of manifest error. Community law is neutral with respect to public or private ownership of the undertakings providing them. The Commission will oversee to ensure proportionality, that is, that any restrictions on competition are no greater than is necessary to guarantee effective fulfilment of the mission. Principles for defining and providing services include clear definition of basic obligations about quality, health and safety, transparency about tariffs and providers, choice of service (and, where available, of provider) and regulatory oversight that is independent of the operator and provides for complaint handling and redress. Article 16 of the Treaty admonishes Community institutions and Members to take care to operate services of general economic interest on the basis of principles and conditions which enable them to fulfil their missions. This language was added by the Treaty of Amsterdam. Its precise content is not entirely clear, since it includes a proviso that this is to be without prejudice to Articles 86 and 87. The addition was probably intended as a signal to the Commission to be more cautious in dealing with public service sectors. (Goyder, 2003) In any event, recent liberalisation directives in sectors such as electric power and gas have come from the Council.

The Commission has the power to issue decisions and directives to Member States implementing Article 86. The first broad sector reform directive, concerning telecommunications equipment, was such a Commission initiative, responding to evidence of widespread abuses. The ECJ upheld the Commission's use of this power rather than seeking Council legislation or bringing a particular enforcement action against the Member States. The amended Commission directive set out key elements of permissible special rights, notably that the criteria for granting limited rights or conferring advantages must be objective, proportional and non-discriminatory. The latest generation of the regulatory framework for electronic communications, which applies from July 2003, builds on principles of EU competition law. It imposes ex-ante regulation only on undertakings with significant market power in markets not subject to effective competition, and it foresees progressive withdrawal of regulation as markets become competitive.

Labour is not subject to Community competition law. The Treaty covers labour separately, in Article 39. Employees are not undertakings; rather, they work for undertakings. Trade unions would be considered undertakings to the extent that they enter into commercial activities, but not when they are

dealing with labour market issues. In general, agreements concluded in good faith on core subjects of collective bargaining, such as wages and working conditions, which do not directly affect third markets and third parties are beyond the scope of Community competition law.

Intellectual property rights receive special attention in the context of the internal market. Article 30 permits constraints on imports and exports, which are otherwise strictly prohibited, if they are justified to protect industrial and commercial property. These parts of the Treaty are directed to Member States. They are invoked in controversies about the permissible extent of control over parallel importation of trademarked and patented products. The outcome of these controversies has important implications for the state of competition in European markets, but the issues do not arise under the competition law and are not under the jurisdiction of DG Competition.

There are no sectoral exclusions from Community competition law. Where the Treaty structure appears to create exclusions for particular sectors, notably agriculture and transport, the result has been a tailored enforcement regime applying essentially the same principles. The block exemption power has rarely been used to exclude firms in a sector from the application of the competition rules. The Treaty's use of the term "exemption" is a confusing usage. Non-specialist observers sometimes understand it to mean that a block exemption regulation for a sector frees it from the obligation to comply with Community competition law. "The Commission on principle dislikes sectoral block exemptions unless the characteristics of the sector are so special, and the lobbying power of its members so great, that a tailor-made block exemption is inevitable" (Goyder, 2003, p. 527). The principal example was the motor vehicle block exemption regulation, whose original motivation and effect was more like an exclusion, explained not so much by a cost-benefit balance of market effects as by the political influence of the national-champion auto industries. The regulation was recently revised to make it more restrictive in this industry than the general vertical restraints exemption. It will be coming up for review again within the next 5 years. The Commission has made it a priority to concentrate on continuing problems in that sector.

Agriculture: Agreements that form an integral part of a national market organisation or that are necessary to attain the objectives of the Community's Common Agricultural Policy (CAP) are exempt from the prohibition of Article 81, but not from Article 82 or merger control. The exemptions follow from Article 36 of the Treaty, which authorised the Council to determine to what extent the Treaty's competition rules apply to production and trade of agricultural products, and the regulations that the Council has issued detailing the scope of the exemption. The exemption only applies to certain products (specified in Annex I to the Treaty). National market organisations are not

exempted if there is a corresponding Community-wide organisation. Now that most commodities are covered by Community-wide organisations, the first part of the regulation's exemption is less important. Agreements concerning co-operatives can only include farmers and their associations. Including a processor, such as a slaughterhouse, removes the protection of the exemption. They should be limited to a single Member State, and they may not impose an obligation to charge identical prices, exclude competition or jeopardise the CAP objectives. The exemption related to the CAP is subject to conditions related to the CAP's purposes. Several of these purposes, such as increasing incomes, stabilising market and ensuring supplies, imply protecting the agriculture sector against market forces. Others, such as improving productivity and ensuring supplies to consumers at reasonable prices, could be conceived as not inconsistent with competition policy goals. The Commission and the courts typically presume that the CAP's objectives are fulfilled by the establishment of common market organisations, and thus are more sceptical of agreements outside and beyond that framework. Regulations setting up Common Market Organisations may introduce some variations and cover additional products, but they typically follow the same pattern and may also explicitly deny the exemption to hard-core price-fixing. Community competition policy in this sector is administered by DG Comp, although state aid cases are dealt with by the Agriculture Directorate-General.

Ocean shipping: Council block exemption regulations govern the application of Community competition law to ocean shipping conferences and to intra-Community maritime freight transport. The justifications offered for this special treatment include price stability, service reliability and efficiency. The basic regulation covering liner conferences dates from 1986, permitting coordination of timetables and agreements about frequency of sailing and calls, allocation of sailing and calls among members, regulation of capacity and allocation of cargo or revenue. Agreements between conferences and shippers are permitted but regulated to prevent harm from discriminations that are not economically justified. Another series of exemptions, the latest issued in 2005, has permitted agreements about "technical" matters but not price fixing. Like other recent block exemption regulations and guidelines, it provides a market-share safe-harbour, of 30%. The regulations do not provide a blanket exemption, and the Commission has pursued several infringement actions against conferences, notably for agreements about services beyond what the exemption permits, such as agreements outside the range of the conference or concerning inland legs of multi-modal service. A Commission white paper in 2004 has considered a proposal to withdraw the current block exemption schemes for liner conferences and enforcing general competition rules, even to cabotage and tramp vessels.

Aviation: The original enforcement regulation exempted air transport from competition law oversight. That was changed in 1987, when the Council gave the Commission some powers to regulate and grant block exemptions concerning air transport within the Community. A new Council regulation in 2004 expanded that power, so the Commission can now apply competition law concerning transport with third countries as well. An exemption regulation dating from 1993 that permitted IATA interlining agreements was due to expire in 2005. DG Comp has been considering whether to recommend retaining it with changes, or simply allowing it to expire, since the post-liberalisation industry has evolved in ways that make the historic agreements no longer important enough to justify special treatment.

5. Competition advocacy and policy studies

DG Comp is putting a higher priority now on promoting and protecting competition through screening proposals from other quarters of the Commission and on analysing market problems and advocating reforms in Commission and Member State laws and regulations. According to the latest mission statement, “a key aspect of DG Comp’s future mission is to contribute to the shaping of other EU policies and national regulatory frameworks in order to promote a regime favourable to competition (competition advocacy)”. In the past, screening of proposals from other Directorates and developments in Member State legislation has often been defensive. DG Comp would like to move to a more pro-active advocacy role in the development of Commission legislation and policy guidance.

Commission guidelines about impact analysis for proposals, issued in June 2005 after a long process of consultation, highlight competition issues. A formal impact analysis is required for items on the Commission’s Work Programme, such as regulatory proposals, White Papers, expenditure programmes and negotiating guidelines for international agreements, and the Commission may decide to require impact analysis for other items too. Impact analysis is not required for Green Papers launching consultation processes, regular decisions and reports, proposals following international obligations or decisions implementing the Commission’s powers to implement Community law. The prescribed process contemplates that other directorates will be alerted early on, and normally an inter-service steering group will be established to follow the course of the proposal and the analysis. Where the process leads to a proposal for action, the required impact analysis report is subject to formal inter-service consultation before the proposal and the impact analysis are presented to the college of Commissioners. The 2005 Guidelines for doing impact analysis uses a hypothetical reform of regulations that prevent competition and entry in Europe’s sugar market to illustrate the steps and considerations. The annexes to the Guidelines include an outline of the kinds

of problems that might call for solution. A principal heading, after the listing of the Community's explicit treaty goals themselves, is "market failures", including externalities, undersupply of public goods, missing markets, imperfect information and insufficient competition. The explanation of "missing or weak competition" cautions against over-reliance on market structure as evidence of weak competition, and it points out the need to consider actual market performance and the likelihood of entry, as well as the problem of regulating natural monopoly.

It remains to be seen how impact assessment will work in practice. Only a few items on the roster of proposals and impact assessments that have been posted to date might have had a significant competitive impact. Some that appear more likely to have a market impact are listed as "restricted", evidently because they deal with positions the Community may take in trade negotiations. Each Directorate is responsible for impact analysis of its own projects, including the assessment of their impact on competition. In some areas, regulations prepared about other topics have been designed well to take advantage of competition and market incentives, without substantial intervention or advice from DG Comp. For example, the carbon dioxide trading regime developed by the Environment Directorate is an economically sophisticated regulatory tool. Nonetheless, to help the other Directorates-General, DG Comp has prepared a concise guide to competition screening. This guide is posted on its website under the heading "advocacy". The guide instructs that the kinds of proposals most likely to have a competition impact are those dealing with liberalisation, industrial policy and the internal market, followed closely by ones granting exclusive commercial rights or exempting activities from competition rules. Sectoral rules about environmental, industrial or regional policy that affect economic activity and general rules that affect commercial behaviour also may deserve attention. It emphasises that screening to identify restrictions on competition and less restrictive alternatives could help achieve desired goals without disproportionate constraints on competition. The guide then illustrates possible applications with examples: exemptions from competition rules for agriculture, preventing competition for waste management and accreditation, mandating product characteristics, setting maximum prices or minimum standards, restricting advertising, limiting distribution, eliminating uncertainties and promoting excessive transparency in procurement, restricting access to resources or requiring licensing or testing new products in concentrated markets, and designing rules in ways that *de facto* favour incumbents.

DG Comp does not have a separate unit responsible for advocacy and screening. Rather, projects are assigned according to expertise in the sector or issue. The current management plan sets out the expected outputs for 2005: a Commission working paper on the water sector, a proposal to abolish the

Council block exemption regulation for maritime conference price fixing, an amended block exemption regulation about liner shipping consortia, a report on progress in reforming professional services regulation, rules incorporating competition principles in agricultural Common Market Organisations and a contribution to the crop protection directive. In addition, the sector inquiries in financial services and energy may lead to proposals to reform regulation. One of the announced motivations for these inquiries was that regulations in place had not succeeded in displacing national incumbents from their protected positions and establishing an integrated common market.

Enforcement experience backs up advocacy advice and the liberalisation agenda. A chief example is the long-running reform of telecommunications, from its beginnings 20 years ago with an infringement action. This has continued in energy and transport, where Commission decisions about mergers and infringements complement the development of directives for reform. Where application of Community policies depends on action by Member State governments, oversight is more difficult and more delicate. Member States may introduce elements that affect market competition, perhaps unwittingly. For example, some Member states implemented the Community directive about petroleum security stocks in a way that effectively prevented new entry into retailing.

The most prominent recent reform project is about professional services, concentrating on lawyers, notaries, accountants, architects, engineers and pharmacists. The Commission released an extensive report in 2004 about competition in professional services. Problems it identified included fixed and recommended prices and regulations restricting advertising, entry and business structure. Acknowledging that some regulation is justified to protect consumers in these areas, nonetheless the report called for using more pro-competitive mechanisms. The Commission points out that restraints imposed by private bodies such as professional associations could violate Article 81 (unless they are objectively necessary to guarantee the proper practice of the profession as it is organised in a Member State). State regulation that impairs competition violates treaty obligations, and if a Member State delegates power to a private entity without sufficient safeguards, the Member State could also be liable for a resulting infringement. But after thus reserving the possibility of enforcement action, the Commission invited the Member States and the professions to review and reform unjustified regulations. It has promoted a series of bilateral meetings to give the professions and national regulatory authorities an opportunity to explain their positions, recognising that the project will necessarily involve national professional bodies and regulatory authorities and competition agencies, as well as consumer groups. Member States have also been encouraged to compare experiences. A follow-up report, "Professional Services – Scope for more reform", was published on

5 September 2005. This gives an overview of progress made by Member States in the review and removal of unjustified regulatory restrictions. It welcomes progress made in some Member States but finds that regulations that seriously restrict competition are still too common in many countries. Progress is hampered by a lack of national political support for reform and little appetite for reform from the professions themselves. The Commission calls on Member States to take decisive action and suggests that the issue of modernising the rules affecting the professions should be built into the national reform programmes for implementing the Lisbon Strategy. It concludes by reiterating its commitment to wide-scale reform and leaves open the possibility of further enforcement action.

6. Conclusions and policy options

Competition policy played a central role in the development of the EU and its institutions. It has achieved a quasi-constitutional status, distinctively based on the direct application of law to economic actors rather than on administrative exercise of policy discretion or on political or interest-group bargaining. With broad jurisdiction and what some observers described as an evangelical, even moral commitment to free market ideas and their constitutional role, DG Comp was recognised by the 1990s as a particularly effective agency in the EU system (Wilks and McGowan, 1996) (Goyder, 2003). Competitiveness is replacing market integration as a driver of policy, but it appears unlikely that competition policy will have to make a political compromise with industrial policy. Historically, the Commission has shown a pragmatic appreciation of Europe's need to be competitive and realistic tolerance of national interests. Productive efficiency and consumer welfare appear to have equal priority as goals of the restated competition policy based more explicitly on economic concepts.

The strong relationship between the Commission and the courts remains fundamentally important. Early support from the ECJ, which was interested in the market integration theme and in strengthening EU institutions, encouraged a conception of competition policy in terms of legal categories. As the Commission now moves toward a more explicitly economic point of view, a new understanding with the courts will have to be worked out, about how the courts will deal with economics and the Commission's claim to economic expertise. Convincingly and consistently presented, economic analysis could substitute for legal soundness as an anchor against politically-driven manipulation of policy outcomes.

Completion of the policy framework and ambitious application of it revealed some problems, which the Commission has moved to address. Important reforms and achievements since the mid-1990 included turning

attention away from vertical agreements, using a leniency program to bring more effective challenges to clandestine horizontal collusion and replacing the notification system and the “comfort letter” paste-over. The liberalisation program, which had begun in the 1980s with telecommunications, has extended competition to network sectors. But implementation of the merger regulation, buoyed by overconfidence, foundered over defects in analysis, evidence and procedure. The CFI’s chastisement of the Commission in 2002, in effect doubting that the Commission was any more expert than the court about economic matters, has led to welcome improvements in economic resources and important reforms in the Commission’s internal quality control process. The most important reforms, though, are the long-term projects to modernise the content of EC competition policy, by revealing its economic motivation, and to modernise the means for applying it, by ending the system of bureaucratic approvals and extending enforcement responsibility through the entire network of national competition authorities in Europe.

Modernisation of concepts sets out basic analysis in an administrable format while making its economic underpinnings more explicit. In the new approach to guidelines and block exemption regulations, issues such as hard-core misconduct are clearly distinguished from others, and the classifications and presumptions are typically subject to thresholds based on market share or absolute size. There is a single guideline about how to define markets, rather than one for every possible application; however, the guideline is flexible, permitting adjustments to take account of the possibility that a market is, or is not, already operating competitively. Consistency in such matters as the description of “hard core” restrictive agreements also supports increased coherence. The new approach combines recognition of legal distinctions in theory with practical common-sense simplicity in application. The guidelines about horizontal co-operation, for example, parse the logical distinctions and statutory categories but then apply the same market-share thresholds to all, thus warning parties not to bother crafting clever claims about categorisation. The market share thresholds mostly imply negative presumptions, not positive ones; they are plausibly conservative for defining safe harbours to clear the docket and provide some security to business. This now-standard model is well designed for application in a bureaucratic-administrative process, in which precision and nuance in particular cases could not be achieved at acceptable cost with a manageable set of formal rules. Rather, they support clarity and consistency in a comprehensible framework that is accessible and persuasive to the businesses that are subject to it and that is administrable without constant recourse to graduate-level economic theorising. This is not to say that every bright line is drawn in exactly the right place; rather, there may still be room for debate about whether all of the practices characterised conclusively as hard-core restraints deserve that treatment.

The modernised framework replaces legalism with economic concerns about market power and anti-competitive co-ordination. But it does not eliminate all vestiges of formal analysis. Applying it may still require categorisation, for tasks such as identifying “hard-core” conduct whose treatment does not depend on a market share screen. Nor will its application always be straightforward. Treatment of non-hard core matters will depend on market definition, an exercise that can be uncertain as well as disproportionately resource intensive. Market definition is a matter of both fact and judgment, liable to outcome-driven bootstrapping or simple naiveté. Businesses engaged in self-assessment are at some risk to define their markets correctly, although the guidelines typically assure that the Commission will only take prospective action where a company has mistaken a market definition in good faith. Many aspects of the notices and guidelines are explicitly traced to judicial authorities, but others may be explained by administrative plausibility or perhaps by the direction that the Commission would like to take in the future. To the extent the schema takes the form of “soft law” notices and guidelines, it depends on persuasiveness. Their ultimate authority will depend on how the European and national courts treat notices and guidelines that do more than restate the holdings in judicial rulings.

Modernisation of the enforcement process, by eliminating notification and prior approval of exemptions while sharing enforcement responsibility with national agencies, is designed, among other things, to redirect resources so that DG Comp can concentrate on complex, Community-wide issues and investigations. Modernisation shares competence with national institutions in a different way than the Community usually does. It does not follow the paradigm of a directive from Brussels to be implemented through national laws. There are no EU-level directives requiring national governments to adopt a particular substantive competition law, and modernisation does not require substantive harmonisation. Rather, it builds on the fact that the national competition law systems have co-evolved along with the Community system, so that over the years most national governments (and all of the pre-accession Members) have adopted substantive rules that are generally consistent with those of the EU without being required to do so.

The net effect of decentralisation remains to be seen. The regulation establishing the modernised system for co-operative application sacrifices some of the Commission’s monopoly while confirming and expanding the remedies and investigative powers available for Community competition law enforcement. The system is founded on the expectation that coherence will be achieved through common legal principles subject to supervision by the ECJ. So far, the ECN operates by consensus. Depending on developments, though, pressures could lead to demands for greater transparency and accountability, more centralising formality in the network, or devolution of powers to

national authorities (Wilks, 2005). The European competition agencies differ in their capacities and perhaps in their priorities. Some NCAs may defer to DG Comp, and others may take more initiative. Inevitably, the agencies will vary in their technical economic and legal resources and in their degree of effective independence from other policy interests. Strategic reactions from complainants and respondents can be expected. Of course, the process of shopping for the most promising forum is itself a kind of “market test” of the quality of enforcement. The regulation’s provision for the Commission to take over an action should be a sufficient check against weaknesses in the network – unless the Commission is the weak link.

Sharing responsibilities will add perspectives as well as resources. Substantive harmonisation across Europe makes it less critical in most cases to identify an effect on trade sufficient to support Community law jurisdiction. The same principles will be applied, especially concerning restrictive agreements and mergers, whether a matter is handled by DG Comp or by a national agency and whether it is assessed under Community law or national law. The regulation anticipates some variation in how national laws treat unilateral practices by dominant firms, and some differences remain in procedures and resources. There may also be differences among agencies in their capacity and willingness to act, particularly concerning sensitive sectors. The liberalisation projects have demonstrated the importance of a “federal” – level enforcer that can confront entrenched national monopolies. The opposite scenario is also conceivable. Policy disputes among the Commissioners might prevent them from reaching a clear decision whether to take enforcement action about a matter or a sector. An interested national agency might then step up, applying Community law. The Commission could take over the matter in order to preserve its prerogatives, but at least the national agency’s initiative will have overcome the decision deadlock.³⁹

The Commission’s integrated enforcement process, though efficient, has inherent weaknesses. Combining the functions of investigation and decision in a single institution can save costs but can also dampen internal critique. Risk of unchecked discretion may make courts sceptical of the Commission’s decisions. The reversals at the CFI in 2002 made it obvious that changes were needed, and the Commission has taken many steps to address long-recognised concerns about its internal quality controls. More “state of play” meetings and opportunities to expose the staff’s thinking to the parties and to critical peer review are sound. The expectation of close CFI oversight represents a culture change at DG Comp. The net result of the reactions to the setbacks, as well as to the creation of the Chief Economist position and the expansion of the role of the hearing officers, is that case teams understand that they need to put together more and better evidence.

These changes had just been put in place at the time of the OECD's 2003 *Annual Survey*, which included a special chapter on product market competition (OECD, 2003). That survey noted the concern about the absence of checks and balances where the powers of initiation and decision are combined, and it called for an assessment of whether the review panels and other measures made the decision process more effective. The most relevant measure of increased effectiveness will be whether the Commission's decisions are better able to survive judicial scepticism. Few cases reviewed with the new internal processes have completed their way through the courts, so it may be too early to tell. But some cases that have gone through the internal process were dropped or revised as a result, and thus they never got to court. To that extent, the internal checks are doing what they are designed to do.

Checks improve quality but can increase costs. The Commission is still experimenting, to find the appropriate balance between the time and resources needed to put a case together and the time and resources devoted to explaining and defending it internally. Such flexibility can be an inherent advantage of an integrated system. Aspects of the quality control system remain *ad hoc*. Not every case is subject to a peer review panel or the attention of the Chief Competition Economist. For now, it is appropriate to make those decisions case by case, in part because there are not nearly enough resources available to give that attention to everything. But as the allocation of cases among agencies evolves, most of the docket at DG Comp may be the more complex and controversial matters for which in-depth analysis and critical scrutiny are most necessary. If so, then *de facto* these internal steps may become expected rather than extraordinary.

Some explicit separation between the investigative and decision-making functions may be inevitable, to secure judicial confidence in the quality of the Commission's decisions. One option for more transparent separation within the Commission process could be creating a more formal evaluative role for the hearing officers. These officials now deal primarily with ensuring process fairness, more than with assessing the substantive merits. Nonetheless, if they have views about the merits, the process already provides some opportunity to convey them. It would a challenge, though, to create such a role that stops short of a full internal administrative trial and initial decision, a process that could just add a layer of delay.

The Commission-level decision process is another quality check, but it is not without problems. The Commission has a key independent role in the Community governing structure, as an institution that is charged with acting in the interests of the Community as a whole. By contrast, the Council and the Parliament are political bodies that must be responsive to national and other interests. The Commission's historic strength has been its appearance of impartiality with respect to national rivalries. Even so, observers in the mid-

1990s noted concerns that Commissioners might tend to favour their policies and interests, subliminally if not overtly. (Wilks and McGowan, 1996) No other jurisdiction in the OECD assigns decision-making responsibility in competition enforcement to a body like the Commission. With 25 members, the Commission is too large to effectively deliberate and decide fact-intensive matters.⁴⁰ Realistically, the Commission defers increasingly to the Competition Commissioner, providing some high-level policy control over the Competition Commissioner's initiatives. The Competition Commissioner may have consulted with the Legal Service, Hearing Officer, peer review panel and Chief Economist, and the Commission may have before it opinions from the Advisory Committee or other Commission services. But when the Commission decides a matter, it has typically not heard directly the case against the proposed decision. No Commissioner, including even the Competition Commissioner, will have attended the hearing. All depend on briefings from staff, and there is no *ex parte* rule or other control on contacts between investigating staff and the Commissioners who decide the matter. There is no initial adjudicator that is fully independent of the investigative function.

It is thus not surprising that courts are moving into what looks like a first-instance role. At least, since the CFI was created the courts have not given the Commission much leeway about evidentiary matters. The potential for judicial review and annulment shores up deficiencies of the Commission decision process under principles of European human rights law about impartiality and independence. But the current court system would be taxed to the limit by a true first-instance decision responsibility. To be sure, the courts have risen to the occasion when called: in the 1975 *Sugar Cartel* case, the ECJ produced a 200 page judgment (nearly 500 pages, in CMLR) to examine claims about individual markets and the interaction of competition and agricultural policies, and the full judgment of the CFI in the 2000 *Cement Cartel* cases runs to nearly 1 200 pages. And the CFI was created to increase the judiciary's capacity to handle fact-intensive review. The "fast track" procedure there has made this a realistic possibility even for time-sensitive cases such as mergers.⁴¹ The scope of review and thus the role of the courts are evolving. Recurring issues in competition cases, such as market definition and assessing net effects of agreements and transactions, show that it is not always clear where to draw the line between matters of fact and evidence that are subject to judicial review and matters of complex economic analysis that in principle should be entrusted to the Commission's expertise.

If a separate court took on more responsibility for making records and deciding cases, it would likely play a larger role in determining policy too. As Community competition policy moves beyond law-driven market integration toward a more economic approach, courts may need to articulate a more coherent conception of competition and policy goals (Gerber, 1998). Perhaps a

specialist competition court could fill that role. Changes to the CFI's status due to the Treaty of Nice prepared the way by giving the CFI its own basis for jurisdiction and authorising it to annex panels to hear matters in the first instance, with an appeal to the CFI. Though this was conceived as an outlet for staff cases, it might foreshadow the creation of a separate competition court as a first-instance decision-maker⁴² (Goyder, 2003). But creation of a new "cartel court" at this time would be premature. It would undermine the role of the Commission and the Council in setting policy direction, and it would encourage DG Comp to act more like a prosecutor than a decision-maker. Short of changing the courts' basic function in the process, they might be given more comprehensive powers to consider Commission decisions on the basis of appeal rather than judicial review. The European courts now review Commission decisions for legal and procedural deficiencies, exercising full control only over the sanctions imposed. If the court rejects the Commission's finding of infringement, it can only annul the decision and send it back to the Commission for further proceedings. An alternative would be to authorise a full appeal, leading to entry of final judgment by the court.

Resources appear sufficient for DG Comp to deal with Community-wide cases and policy development and co-ordination. Inadequacies noted in the 1990s have evidently been overcome (Wilks and McGowan, 1996). Indeed, now that the national competition agencies apply Community law, public resources committed to competition enforcement in the EEA are substantially greater than in the United States. To be sure, Europe does not yet have such a large contingent of non-government lawyers and economists engaged in supporting and defending private antitrust enforcement.

The 2003 *Annual Survey* called on the Commission to consider economy-wide welfare losses in setting priorities. The Commission has long set its overall priorities based on an understanding of the likely net economic effects of enforcement intervention. For example, a judgment about the net economic impact motivated the shift of resources and attention over the last ten years from vertical restraints to horizontal cartels. At the smaller scale of choosing individual cases, though, it is not often feasible to rely on suppositions about large-scale welfare losses. The high priority given to hard-core cases is based on considerations of general deterrence rather than predicting the effect of stopping any individual cartel. For non-hard core cases, the net effect might not be very clear at the outset. Nevertheless, DG Comp is trying to improve its methods for setting enforcement priorities. DG Comp's 2004 annual report calls for enhancing the pro-active nature of policy-making, to remedy market failures in support of the competitiveness agenda, while providing for enforcement action at the most appropriate level in the enlarged EU (EC DG Comp, 2004). The comparative advantage of the 26 different authorities is now highly relevant. The Commission obviously ought to take the lead on matters with international

or Community dimension, or where the key factor is a Community based regulatory program, such as network infrastructure. Allocation of resources is shifting already in response to these priorities. DG Comp has doubled its resources for cartel enforcement over the last year, resulting in a doubling of enforcement activity too (measured by statements of objections issued).

Creation of a special cartel directorate was announced as an innovation; however, in 1998 and again in 2002, DG Comp had previously announced the creation of special new cartel units. Whether or not the directorate is particularly new, it is necessary and welcome. The special merger directorate was disbanded because mergers no longer present procedural and legal novelties; a special cartel directorate is needed because the new enforcement structure presents novel and sensitive legal and practical problems, concerning jurisdiction, leniency and investigative powers. Cases are multiplying and respondents are likely to put up sharper defences. The cartel directorate's special expertise is about issues that are likely to be of particular sensitivity in the courts, about investigative process and the quality of evidence. As fines increase to levels that persuade companies to contest liability as well as the size of fines, the quality of proof will become even more important. The confessions and insider evidence produced by the leniency programme have been invaluable. But DG Comp does not want to rely too much on leniency, perhaps concerned about litigation over tangential issues or judicial rejection of leniency-prompted evidence. DG Comp is thus looking for economic indicators of horizontal collusion that would identify targets for further investigation. It remains to be seen whether economic data and analysis alone will persuade courts to authorise coercive investigative techniques. So far, it does not appear that DG Comp expects to rely on such an analysis, in the absence of more direct evidence, to persuade courts about the substantive merits or appropriate sanctions.

A new notice and guidelines about sanctions and remedies is in preparation. The principal topics are likely to be cartel fines and the leniency program. The 2003 *Annual Survey* recommended assessing the deterrent effect of sanctions, implying that the fines being imposed were not large enough. Sanctions being imposed against horizontal cartels in the Community generally match the levels being imposed elsewhere, and sanctions against abuse of dominance appear even stronger. But recent research shows that cartel overcharges have historically been even greater than enforcers had believed, averaging over 30% in EU cases and well over 40% for international cartels (Connor, 2004). Sanctions everywhere may still be too low to deter effectively. The process of preparing a new notice is an occasion for assessment of whether the Community's sanction level is effective. The notice may also lay a foundation for the use of new powers of structural relief and divestiture. Other improvements in remedies include clear authority for interim measures and binding commitments and power to

withdraw the benefit of block exemptions. The provision for enforceable commitments is valuable, although the recital that they will not be accepted in a case where the Commission began by seeking financial sanctions is curious. It implies that, once the Commission demands a fine, the respondent must either pay it or take the Commission to court, with no possibility of reaching a compromise resolution about commitments before the court rules. This limitation on the Commission's negotiating flexibility may have been unintended.

The informal network of enforcement authorities is off to a promising start. Deliberately setting up a new non-institution in the ECN, rather than building on the already-established Advisory Committee, sends an interesting message. The distinction appears intended to keep the ECN informal and to avoid, or at least postpone, a legalistic process of binding expectations and commitments. The fact that the ECN has no legal status raises questions about accountability, and its process has raised concerns about transparency (Wilks, 2005). Experience will show whether it is necessary or prudent to make the system more formal. For now, consensus-driven informality is a good setting to learn about the different capacities of the 26 agencies.

Guidelines are under consideration about abuse of dominance under Article 82, seeking to develop an approach that is coherent with the modernised conception of Article 81. Thus, the guidelines might examine factors analogous to efficiency claims under Article 81(3). Since Article 82 does not provide for balancing other considerations against the prohibited conduct, apart from the doctrine of "objective justification", the argument would have to be that in the presence of a demonstrated efficiency conduct does not amount to abuse. Practice under Article 81 provides an analogy, as court judgments sometimes disregard subtleties that distinguish whether a factor is relevant to the Article 81(3) exemption or to the Article 81(1) prohibition. The principal topic of the possible guidelines will probably be the treatment of exclusionary abuses. Clarification of policy about exploitative abuse would be welcome. The absence of cases challenging exploitative abuse implies that the Commission is reluctant to police price levels like a utility regulator; on the other hand, the Commission has not foresworn the power, which the courts have recognised even though they have never authorised the Commission to use it. Relying on soft-law guidelines to persuade the courts to modernise the approach to Article 82 presents a challenge. Much of the lack of clarity about whether the basis of the law is preserving market relationships or improving economic performance can be traced to still-authoritative early ECJ judgments.

Clear process and deadlines have been a strength of the EC merger control system, and the recent changes in those dimensions are incremental improvements. The most important changes are the possibility of extending deadlines in order to discuss remedies and the provision for notifying a non-

binding agreement. The changes also seek to reduce procedural complication and uncertainty in the allocation of jurisdiction among the Commission and national agencies. A national agency no longer must demonstrate dominance in its market before getting a referral from the Commission, and the merging undertakings can take the initiative to suggest the appropriate venue. After fifteen years of experience with Community merger control, experiments and habits have evolved into efficient “best practices”, which are now the subject of extensive soft-law guidance. Notably, informal pre-notification contacts with DG Comp are strongly encouraged. In some other jurisdictions, over-reliance on pre-notification contacts and negotiations outside the formal merger control requirements have been criticised for non-transparency. In the EU context, though, where there is a realistic opportunity for timely judicial review to correct abuse of the enforcer’s discretion, this is unlikely to be a problem.

State aid regulations are another topic for recasting into the modernised format. The 2003 *Annual Survey* called for reducing state aid generally. The *Annual Survey* acknowledged that the European Council in 2002 had already adopted a policy of “less aid, but better”, targeted to remedy real market failures. The Commission is moving to implement that approach, and the review of the state aid rules launched in 2005 is a step toward that goal. The Competition Commissioner has recognised that state aid control is critical to improving competitiveness, because improper aid anaesthetises the market and prevents it from achieving efficiencies (Kroes, 2005). The subject is too technical and wide-ranging for detailed treatment in this report. The opportunities for controversy are obvious, as competition principles confront industrial and other policies. Concerning the important general issue of how state aid rules relate to Treaty rules about public services, the ECJ’s recent *Altmark* ruling established a useful practical framework, which the Commission has embraced. Some questions remain to be answered. The ruling leaves open whether cost coverage that is not treated as aid includes provision for any benefits received from performing the public service function. Nor does it indicate the level of profit that would be considered reasonable or how to find a benchmark where there is no typical comparable private firm (Louis, 2004).

The liberalisation program that has been central to the DG Comp mission since 1986 is not completed, but the course is laid out. The principles of separation between monopoly and competitive functions and encouragement of trans-national markets have long been well understood, at least at the Community level. The 2003 *Annual Survey* demanded accelerated liberalisation of network industries, especially those that were lagging. But for the sectors where changes have been most difficult, notably rail and postal services, further reform depends on the Community’s political decision-making process to

overcome protections of national incumbents. The *Annual Survey* also recommended clarifying and limiting the jurisdictions and powers of sector regulators that overlap competition policy, to be sure they are not protecting their national markets too much. It is not evident what more needs to be done, though, to ensure that Community competition policy would override inconsistent national regulation, subject to the general principles of Article 86 and relevant Community directives.

No sector is completely excluded from Community competition law, although special treatment applies to aspects of agriculture and transport, particularly ocean shipping. These are sectors that commonly get special treatment elsewhere. Careful attention is called for to ensure consistency in sector-specific application of state aid and other general competition rules here. DG Comp has been vigilant, promoting reform and repeal of some of the block exemption regulations. More generally, the Commission has adopted a new procedure for reviewing the impact of proposed regulations, and DG Comp has made it a priority to become more active in this “screening”, to head off or correct regulatory initiatives at the Community level that hamper competition. The extent to which other the parts of the Commission are committed to pro-competitive reform of their regulatory programs remains to be seen.

National-level regulation of professional services is a key object of advocacy and reform. The Commission’s nuanced approach to this subject has been realistic and comprehensive. DG Comp sponsored a thorough study and report as a foundation for further action. That has been followed by a combination of admonition and encouragement, seeking to form a consensus about change but reserving the potential for enforcement action. The 2003 *Annual Survey* recommended stronger action toward a single market in services. The project about professional services shows how DG Comp is contributing to that goal, whose success depends ultimately on action at the national level.

In 2005, DG Comp launched sector inquiries in finance and energy to determine whether private constraints or public regulations were impairing competition. These projects follow through on the Commissioner’s determination to use competition policy to improve competitiveness. (They also show how DG Comp is promoting a stronger role for competition authorities in development of common financial services, as the 2003 *Annual Survey* recommended.) The inquiries are a welcome application of the Commission’s previously underused power to investigate in sectors where competition looks problematic even though no particular infringement is suspected.⁴³ Financial services and energy were chosen because making the supply of these inputs more efficient would have multiplier effects on competitiveness. But they also present opportunities to demonstrate how

competition could encourage innovation and reduce prices for services provided directly to consumers.

6.1. Policy options for consideration

6.1.1. Clarify the relationships among the leniency programmes of the Community and the national enforcement agencies

Companies that are exposed to investigation and potential liability in several jurisdictions have raised a number of concerns, unsure about how a leniency offer or commitment in one jurisdiction affects their rights and risks in others. There is no single point of contact, so companies must make multiple applications. There are no programs in 8 Member States (although 4 are considering them), so companies might be exposed there despite receiving leniency elsewhere. And the terms of the programs differ. Some programs cover vertical agreements, others do not. The Commission's program now permits leniency to instigators, but others still follow the earlier approach. Parties after the first one get different deals in different countries. Some permit the applicant to remain in the cartel if obvious abandonment would tip off the others, but the Commission frowns on this. Some demand more evidence than others in order to claim first place in line, thus forcing a choice between speed and completeness. Some will accept oral statements, which companies prefer in order to avoid exposure in the US, but others do not. Despite these variations, though, no case of serious disagreement has been reported yet.

The risk that a leniency applicant would be exposed to criminal liability in other jurisdictions is probably not significant, although it is often raised. The text of the Treaty supports a legal argument that national bodies could not bring criminal actions following Community enforcement and grant of leniency (Levy, 2004). The Commission's upcoming notice about remedies might make that even clearer. The same result could be accomplished through commitments from the national agencies not to pursue criminal prosecutions in those circumstances.

The 2003 *Annual Survey* called for exploring options for making leniency more attractive, particularly concerning co-operation with Member States. DG Comp recognises that addressing this issue is a top priority. But it need not result in a single, integrated system, at least not yet. There is still room for experiment to improve the tools. The goal is to maintain the incentive to confess that result from the crucial features of transparency, certainty and asymmetry. The only aspect of the programmes that appears to present a risk of actual conflicting demands now concerns whether the leniency applicant must cease participation, as some agencies might not want an abrupt change to tip off others prematurely. That risk is reduced, however, by an agreement reached within the ECN that an agency with discretion will exercise it to avoid

that conflict. Reducing other administrative complications and unnecessary variations is unlikely to present serious difficulties. Short-form applications in some jurisdictions already simplify the process, for example. Co-ordination and functional equivalence of conditions and procedures among the jurisdictions' programmes could lead to the same efficient outcome as a "one-stop shop". It may be prudent to get more experience with the courts, to see how they treat fines that result from leniency offers, before going too far into detail.

6.1.2. In adopting an economic approach to dominance, make liability depend upon effects that harm competition; in appropriate cases, assessing the scope for recoupment should be an integral part of such an approach

A thorough-going economic approach to dominant firm conduct requires some methodologically clear means of identifying claims about exclusionary conduct that present threats to sound competition and distinguishing them from demands by competitors for help in keeping prices up. This implies a finding that the market is likely to suffer the effects of monopoly exploitation as a consequence of the abusive conduct. For example, where the allegedly exclusionary conduct entails a short-term sacrifice of the dominant firm's profit, to impose liability where those losses could never be recouped could discourage vigorous competition. Requiring a separate showing about this could be a matter of form, though, more than substance. The conclusion is implicit in a conception of dominance that includes the presence of entry barriers sufficient to protect against erosion of monopoly gains. In developing the new Article 82 guidelines, there are a number of other sensitive issues for which the correct approach may be less clear. These include the treatment of intellectual property rights and claims about network effects and essential facilities, as well as whether to include or ignore concepts of "economic dependence" that cannot be tied to coherent theories of economic effect on market competition.

6.1.3. Increase further DG Comp's capacity for economic analysis

Correcting a long-recognised resource limitation, the office of the Chief Competition Economist now makes sophisticated analytical resources available in-house. Already, as Community competition analysis has increasingly relied on economic reasoning, DG Comp had greatly increased the proportion of staff with economic training. The new office represents quantum increase in the level of economic expertise, but the office is small and it is stretched thin. The *ad hoc* method of allocating its limited resources is not necessarily a problem. Not every case needs its attention, and trying to specify a protocol in advance for identifying those that do may be more costly than just leaving it up to case

handlers to request and the DG to decide case by case. But more will be needed, particularly if more complex and difficult matters come to dominate the DG Comp caseload. Staffing this office with a combination of permanent employees and academics rotating through on temporary contracts is a sound approach, bringing new ideas into the enforcement bureaucracy and practical insights into academia. The advisory group, institutionalising DG Comp's relationship with Europe's academic community, is another valuable step. These are the experts who are likely to occupy the position of Chief Competition Economist in the future.

6.1.4. Consider means for extending sanctions to individuals as well as firms, such as co-ordination with application of Member State laws that provide for individual sanctions

The prospect that individuals involved in infringements would be exposed to sanctions could improve the effectiveness of cartel enforcement. The terms of the Treaty could support administrative fines against individuals for conduct that was part of an infringement, although there is no jurisprudential or constitutional basis for Community criminal liability. But fines might not be as effective as other sanctions against individuals, though. Extending the process of investigation and enforcement to individuals would raise a number of difficult and complex legal issues and additional costs, and it would strengthen the case for making the courts the principal decision-makers (Wils, 2004). If an effective individual sanction at the Community level is deemed impossible or imprudent, the obvious alternative is for the Commission to promote and support the imposition of individual sanctions under the national laws of Member States.

The 2003 *Annual Survey* recommended another means of expanding the reach of enforcement, by encouraging the use of private suits. The Commission has been doing so since at least the early 1990s. This is primarily a matter for national law, though. Informal efforts to encourage private actions continue, and more resort to private litigation in national courts is expected to be a by-product of modernisation. Richer articulation between Community-level principles and national competences concerning private remedies and criminal sanctions could extend the base of support for competition policy.

Commissioner Monti, in his final annual report, called for better definition of the role of consumers. Designation of a contact point high on the DG Comp organisation chart is a modest step in that direction, to co-ordinate better with the parts of the Commission that are handling consumer protection and product safety issues and perhaps with consumer NGOs. More important, though, is effective, persuasive communication of the value of sound competitive markets, not just to policy officials and advocates nor even to the businesses in Europe that are affected directly, but to the citizens of Europe who benefit.

Notes

1. The Maastricht treaty renamed the European Economic Community as the European Community (referred to below as the “Community”), while creating a new construct, the European Union “founded on the European Communities”. The competition rules appear now in the Treaty Establishing the European Community, referred to below as the “Treaty”.
2. The constitutional treaty that has been submitted for ratification would make it explicit that the European Union has legal personality.
3. Competition law ideas in Europe had a trans-national dimension since the 1920s. The image and model of appropriate competition laws were formed at the League of Nations’ World Economic Conference and the Interparliamentary Union’s London Conference (Gerber, 1998). By contrast, in the first new pan-European institution set up after the war, the Organisation for European Economic Co-operation, there were discussions of a customs union but no particular attention to other ideas about competition (Goyder, 1998).
4. Although a US antitrust lawyer and law professor, Robert Bowie, is often credited with drafting the competition articles of the Treaty of Paris, they contain no concepts or terms from US antitrust law. The debate over the need for competition rules may have been informed by US experience, but the legislation is European. A member of France’s Conseil d’État, Maurice Lagrange, cast the language into European legal style (Goyder, 2003) (Gerber, 1998).
5. In the absence of an implementing regulation, the Treaty authorised national authorities to apply the Treaty rules, while limiting the power of the Commission over infringements to investigation and authorisation to the national authority to take appropriate action to ensure that they are corrected (Treaty, Articles 83, 84).
6. The Commission’s website and reports classify its substantive programs into 4 categories: antitrust (business practices that impair competition, under Treaty Articles 81 and 82), mergers (under the Merger Regulation), liberalisation (under Article 86), and state aid (under Article 87).
7. Council Regulation 1/2003, which became effective 1 May 2004. A similar approach, of according direct effect to the exemption criteria, was considered during the deliberations about the original enforcement regulation, but it was rejected as premature at that stage.
8. Germany’s cartel law became effective the same day as the Treaty of Rome. The also-new Dutch competition law system was built on registering cartels, not prohibiting them. The drafters of Regulation 17 rejected the Dutch approach, of mandatory notification conferring a presumption of validity, placing the burden on the enforcer to prove abuse and limiting remedies to prospective orders. France had had an *ordonnance* about competition for several years, but it dealt mostly with price control. The other active European competition law systems at that time were outside the EC.
9. In addition, a national law that predominantly pursues a different objective than Community competition law can be applied, as long as that law is not itself in breach of general principles of community law.
10. Article 2 states that the purposes of establishing a common market, economic and monetary union and other common policies are “to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of

competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States”.

11. In the terminology of Community law, regulations are norms that apply generally both at the national and Community level, to Member States and potentially to firms. By contrast, directives are addressed to Member States, binding them only as to the result to be achieved. In implementing the directives in national rules and legislation, Member States can choose the form and method for achieving the required result. The Commission also has power to issue directives under Article 86(3), and Commission directives launched telecoms reforms in the 1990s; since then, though, most liberalisation directives have been issued at the Council level.
12. This phrase appears in both Article 81 and Article 82, describing conduct that is “incompatible with the common market”. Analogous phrases about the Community dimension apply to the other principal subjects of Community competition law. In the Merger Regulation, it is whether the transaction is “compatible with the common market” (Article 2). For state aid, it is whether the support “affects trade between Member States” and is “incompatible with the common market” (Article 87). For services of general economic interest or authorised monopolies, it is that “development of trade must not be affected to such an extent as would be contrary to the interests of the Community” (Article 86).
13. The Commission’s Guidelines on the application of Article 81(3), issued with the modernisation package, set out the principles for applying Article 81(1) and Article 81(3) and collect the relevant case-law.
14. The latest notice, issued in 2001, deals only with whether the effect on competition is appreciable. A separate notice sets out slightly different criteria for identifying an appreciable effect on trade.
15. Changes in the Notice show how the Commission’s appreciation of the risk of market power has changed. The previous Notice had set the thresholds at 5% and 10% and had denied any protection if there were parallel networks of similar agreements.
16. Nevertheless, the competition policy community’s preoccupation in the mid-20th century with the problem of oligopoly co-ordination might explain why the concept was included in the original 1951 ESCS rules.
17. Another problem often encountered in dealing with quasi-collective action is characterising accurately the relationship among affiliated companies. At one time, Community law treated companies in a corporate group as separate undertakings, so agreements among them would be subject to Article 81 unless there was no possibility that the entities could act independently. This “group” construct was sometimes used to extend Article 81 enforcement to parent firms located outside the Community. (Goyder, 2003) It is no longer Commission policy to apply Article 81 to intra-group agreements.
18. Although the effect of combining the two elements of Article 81 resembles the application of a “rule of reason” to determine net competitive effect, that label is resisted. To some observers, the reason to avoid the term is that the rule of reason would consider a wider range of non-economic considerations than Article 81 (Goyder 2003, p. 127). Yet the criteria of Article 81(3), notably the notion of economic “progress”, appear to be broader than the issues about market definition and market

power that are typically considered in applying a rule of reason to determine net effect on competition.

19. Historically, the interpretation of restriction of competition under Article 81(1) tended to be both broad and formal compared to the application of the criteria of Article 81(3), which only the Commission had the power to construe before 2004.
20. Examination of case practice shows that in particular cases Community competition law has the capacity to set fines that approach the level of economic deterrence, that is, that exceed the violator's gain from the infringement, as adjusted for the likelihood of detection and sanction. In the *Lysine* cartel, the Commission's fine against one participant exceeded the company's total annual turnover for the product affected (Joshua 2003). The total base fines against all participants, before adjusting for aggravating and mitigating factors and leniency (EUR 142.5 million), were nearly equal to the participants' total annual turnover in the product affected (EUR 164 million). Whether these fines reached the optimal deterrent level would depend on how long the participants exercised market power and how much their collusion raised prices, of course. It is conceivable that the cartel lasted long enough, and raised prices high enough, that even confiscating a full year's turnover would not capture all of the gains, adjusted for the likelihood of detection.
21. The original regulation 20 years ago had treated the sector more generously than others, leading some observers to consider it a partial exclusion from Article 81. Now, "being regarded as a "special case" has become a burden rather than a privilege" (Goyder 2003, p. 207).
22. Characterisations of abuse in the judicial authorities are too amorphous to guide policy. For example, the seminal *Hoffman-La Roche* ruling of the ECJ describes it as "an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as the result of the very presence of the undertaking in question, the degree of competition is weakened and which, though recourse to methods different from those which conditions normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition".
23. The recital to the Merger Regulation indicates that below a market share of 25% there is no likelihood of creating or strengthening a dominant position.
24. Case 40/70, *Sirena Srl v. Eda GmbH* [1971] ECR 69, 84.
25. Use of this criterion is explained in part by the fact that the legal foundation for the merger regulation is not Article 81 and Article 82. In an early test case, the ECJ confirmed that an acquisition which strengthens a dominant position infringes Article 82, and a later decision implied that Article 81 could also be applied against merger agreements. But rather than build a merger regulation on those decisions, the Council relied on the implementing article in the Treaty's competition section, Article 83, and more importantly on the clause of the Treaty that authorises the Council to fill gaps. Article 308 provides that the Council, after consultations, may take "appropriate measures" where action by the Community is necessary to attain a Community objective but the treaty has not provided the necessary powers. Thus, a premise for the merger regulation is that the system of ensuring that competition in the common market is not distorted, which is a Community goal set by Article 3(g) of the Treaty, requires a merger control system that the

Treaty has not provided, indeed that was deliberately not included in the competition law system in 1957.

26. The Treaty does not preclude a Member State from taking such measures as it considers necessary for the protection of the essential interests of its security which are concerned with the production of or trade in arms, munitions or war material. Such measures must not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes (Article 296).
27. Insiders reported there had been some vote-trading in the early era of the merger regulation, concerning matters arising under the portfolios of other Commissioners (Wilks and McGowan, 1996, p. 234).
28. In the Community's legal vocabulary, an "enforcement" matter is one that the Commission brings against a Member State for non-compliance with Treaty obligations or Community directives or other legislation.
29. This is the system that has long been used to apply French competition law. France had advocated it for the original Regulation.
30. The right to a hearing, to know and respond to the basis for an adverse decision or action, is recognised as a general principle of law in Community jurisprudence. It was the first such concept that the ECJ took from English law (where it is an element of "natural justice"), in a 1974 competition case (Hartley, 1994).
31. Each Commissioner's *cabinet* includes a competition policy specialist. These specialists meet weekly. If a matter raises issues that they cannot resolve satisfactorily, it is discussed at the regular Monday meeting of the Commissioners' *chefs du cabinet*. If there is still no agreement, the matter would be put on the agenda of the Commission meeting on Wednesday.
32. At one time, the starting point was based on turnover, but the Commission no longer applies that approach, in part because of concern that using turnover explicitly would compromise business confidentiality of that data (Joshua, 2003).
33. In the 1996 program, this was 50-75%. The 2002 version makes the promise more asymmetric and thus increases the incentive to be first in line.
34. Full leniency was granted under the 1996 program only 11 times (EC DG Comp, 2004, p. 19).
35. The ECJ may have been nonplussed by the absence of documentary evidence proving agreement and reluctant to trust the Commission's sole judgment in this area (Bailey, 2004).
36. Decentralised competition law enforcement is not an example of the Community law principle of subsidiarity. The term is not used in the enforcement regulation. This principle, which is recognised in the Maastricht agreement, only applies where the Community lacks exclusive jurisdiction. Competition policy is one of the few areas where the Commission has always had direct enforcement power, and it has not been considered an area of shared jurisdiction under the Treaty.
37. The Commission entered a "passive comity" co-operation agreement with the US enforcement agencies in 1991; after a challenge by France to the form and authority of this agreement, it was ratified by the Council in 1995.
38. This is the level budgeted in the 2005 Annual Management Plan. The Antitrust Division of the US Department of Justice is larger, with about 775 staff. Japan's Fair Trade Commission is roughly the same size, with about 640. The JFTC's

jurisdiction includes unfair marketing practices and deceptive advertising in addition to competition law.

39. A somewhat similar dynamic has appeared in the US, when state-level officials or private plaintiffs have taken up issues and cases that the federal enforcers have not pursued. In the US system, though, the federal authorities have no power to intervene and take over state or private actions.
40. The closest analogy is the Competition Commission in Denmark, which has 17 members plus a chair. Unlike the European Commission, it is not composed of officials with policy portfolios, although more than half of its members are designated by associations and interest groups.
41. The 2003 *Annual Survey* raised some questions about the CFI's fast-track process, fearing that it was ineffective since parties who succeeded in their appeals did not necessarily succeed in closing their deals, and recommended an assessment of its effectiveness. The criticism misconceived the purpose of fast-track treatment. The proven benefits of the fast-track option, in providing effective judicial discipline over important but time-sensitive Commission decisions, far outweigh any concerns about whether resource constraints might limit how much fast-track treatment is available.
42. Assigning decision-making jurisdiction to the Community courts might require Treaty changes, at least for merger control decisions. The regulations to enforce and impose fines for violations of Articles 81 and 82 are authorised under Article 83, which gives the Council broad and flexible authority to design the enforcement system. Court jurisdiction under Article 229 is based on reviewing penalties. The legal basis for the merger regulation, though, is Article 308, and the merger control system is not based on imposing penalties (Wils, 2004).
43. The new enforcement regulation adds authority to do this with respect to types of agreement across sectors.

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Predatory Foreclosure

Dominant firms can use various strategies to eliminate or deter competition, including unlawful price cuts or “predatory pricing”. That strategy involves a willingness to absorb losses in the near term that are rational only because they lead to greater profit in the longer term, after competitors have been disciplined or eliminated. Despite differences in statutes across jurisdictions, the roundtable discussion held in October 2004 in the Competition Committee quickly revealed a virtually unanimous view that the purpose of competition laws is to protect and promote competition, not competitors. With respect to methods for detecting predatory prices, including price-cost tests, there was a greater diversity of views because different cost measures are appropriate in different situations. There was broad agreement among Members that investigations should include an examination of whether an alleged predator would likely be able to recoup its predatory losses, with a negative finding indicative of a low probability of harm to competition.

Predatory Foreclosure

1. Synthesis by the Secretariat

Synthesis by the Secretariat

Considering the discussion at the roundtable, the delegates' submissions and the background paper, several key points emerge:

1. Competition law and policy on predatory foreclosure should be used to protect competition, not to protect competitors

There was wide agreement among delegates that the goal of competition law enforcement with respect to predatory foreclosure ought to be the protection of competition, not of competitors. Although the wording of some jurisdictions' competition laws suggests that they aim to prevent harm to competitors, the competition authorities' practice is nevertheless to focus on harm to competition rather than on harm to individual firms. Several tests that help to detect predation, and predatory pricing in particular, take this distinction into account and aim to catch only behaviour that damages competition. For example, most jurisdictions require that an alleged predator's prices be set below its own costs before those prices can be deemed predatory. To penalise a firm simply because its prices are below those of a competitor would be to protect competitors from the effects of competition. Similarly, the recoupment test (discussed further below) does not capture predatory conduct that merely eliminates certain competitors; the conduct must result in the predator's eventual ability to act without the restraining effects of competition.

2. There is no consensus on the best cost benchmark to use in predatory pricing cases, or even on whether an ideal measure exists. Although the average avoidable cost test is gaining support among scholars and practitioners, several delegates expressed a preference for maintaining enough flexibility to tailor the cost measure used to the facts of each case

Practices vary widely among jurisdictions concerning the cost measures used to analyse predatory pricing. Traditional tests such as the average variable cost (AVC) and average total cost (ATC) tests have long been criticised but continue to be used because they often have the virtue of being easier to apply than other cost tests. AVC, for example, has a tendency to drop below marginal cost (a theoretically ideal but virtually unobtainable measure in practice) at the higher output levels where predation is most likely to occur. In some industries, including many of those where network effects are present, it

makes little sense even to try to approximate marginal cost because it is close to zero, whereas fixed costs are relatively high. In other industries, it may be hard to distinguish variable from fixed costs in the first place. ATC, on the other hand, is usually difficult to apply without introducing a degree of arbitrariness into the process. Furthermore, both measures may be too lenient in predatory capacity expansion cases where costs tend to increase in large increments, rather than gradually over specific portions of output. That problem has led several jurisdictions to consider and/or apply the average avoidable cost test, which focuses solely on the range of a firm's output that is allegedly predatory. It also takes fixed costs into account when they are specifically associated with the capacity expansion that accompanies a predatory campaign.

3. A dominant firm's price may be considered predatory in some jurisdictions even if it is above all measures of the firm's own cost

There is no consensus among jurisdictions on the question of whether prices above cost, particularly ATC, can be considered predatory. In New Zealand, for example, although pricing below cost is a relevant factor, it is not requisite to determining that the line between legitimate competition and anti-competitive conduct has been crossed. Setting a price above total costs in Korea could still be considered predatory if that price is below the "ordinary transaction price". Most other jurisdictions, however, do not consider prices to be predatory unless they are below some measure of a firm's costs. The economic rationale underpinning that policy is that an equally efficient competitor would not be excluded by a price that is above all measures of cost. Therefore, to punish firms that merely cut their prices without setting them below cost would be to promote the entry and survival of inefficient firms. That, in turn, would protect competitors rather than competition.

4. The recoupment test should be routinely applied in predatory pricing cases

The recoupment test aims to determine whether a company's allegedly predatory pricing strategy would be likely to eliminate and deter competition, and whether it is likely that the predator would then be able to collect at least enough profit to recover the losses it sustained during its predatory attack. In other words, it does not focus on whether a predatory campaign was actually undertaken, but rather it assumes that one was and asks whether it matters. The recoupment test's primary value is its ability to help competition agencies ensure that they are targeting behaviour likely to harm consumer welfare, and that they do not inadvertently reduce that welfare. The test accomplishes this by screening out cases in which the characteristics of the incumbent firm and the market make recoupment implausible, even if the firm sustained losses with the intent of eliminating competition and gaining the ability to charge

supra-competitive prices. Such conditions may exist, for example, when entry barriers are low or when rivals are well-funded and determined to survive a price war. When recoupment is implausible, consumers are at low risk of long term harm. In fact, they are made better off by the dominant firm's price cutting while it lasts, which is why it could be harmful if a competition agency nevertheless intervenes.

5. Many competition agencies now take recoupment into account in predatory pricing cases, even if the law in their jurisdiction does not require them to do so. Agencies should be mindful, though, that testing for dominance is not equivalent to doing a recoupment analysis

The discussion at the roundtable revealed that a number of competition agencies now habitually consider recoupment theory when analysing predatory pricing cases, even if they do so only as a cross-check to ensure that their conclusions about dominance are correct. Some commentators have suggested that performing a separate recoupment analysis may not be necessary because the process of testing for dominance overlaps with the recoupment test. The overlap is only partial, however. It is important to recognise that the elements of a complete recoupment analysis are not all presently reflected in the dominance test used by most, if not all, countries. Factors such as relative financial strength and excess capacity, for example, are vital in recoupment analysis but usually do not play a role in testing for dominance. Therefore, it should not be assumed that recoupment is plausible whenever the dominance test is met.

6. Because of reputational effects, recoupment does not have to take place in the same market in which predation occurs

A reputation for being willing to absorb losses over time in order to eliminate rivals and discourage potential entrants can significantly increase the likelihood of recoupment for a predator. A predatory reputation may not only have lasting effects on the market in which a predatory attack is carried out, but it could be even more helpful to a business that operates in multiple markets. In that situation, the effects of notoriety gained in one market may echo throughout the firm's other markets. The predator may then be able to reap the rewards of predatory pricing in multiple markets while incurring the costs in only one. This is a rather potent theoretical concept because it means that adequate recoupment does not have to come from the market in which the predation occurred. In fact, predatory losses may never be recouped from the market in which the predation took place, but because multi-market reputational effects may enable the predator to recoup in other markets, the strategy may still harm consumers.

7. Below-cost pricing – even by dominant firms – is not always predatory. Competition authorities should take into account any legitimate business justifications offered by alleged predators

Firms sometimes price below cost for legitimate reasons. For example, even dominant firms may implement promotional pricing from time to time to get rid of obsolete or perishable inventory. In addition, recent studies have shown that setting customers' membership fees below cost in network effects industries enhances competition. Therefore, it cannot be inferred automatically that below-cost pricing is necessarily anti-competitive. To make such an inference, a competition authority should have evidence that such pricing is part of a long run strategy to inflict losses on or deter competitors, so that profits increase in the long run due to the exclusion of competition. Ordinarily, the burden of establishing a legitimate business justification for predatory pricing will fall on the alleged predator. The company will need to show that it was pricing below cost for non-predatory reasons, and it should be able to support the conclusion that it would have set the same prices even if doing so would not have harmed competition.

8. The “meeting competition” defence is recognised in many jurisdictions, but its rationale is not entirely sound and it can be difficult to apply in the presence of non-price competition

The meeting competition defence allows a dominant firm to lower its price to meet the price of a competitor, even if the dominant firm must charge less than its own costs to do so. The defence is often justified by stating that it would be contrary to the purpose of the competition laws to force a company to maintain non-competitive prices, or that even dominant firms must be allowed to compete. Those rationales beg the question of what legitimate competition is. If dominant firms are always permitted to match the prices of any other firm, then even far more efficient entrants may never be able to win the customers they need to survive. Therefore, they may be unable to bring competition to the market over the long run. Furthermore, the meeting competition defence permits incumbent firms to build reputations as aggressive price-cutters who are willing to sustain losses in order to stave off entrants with superior cost structures. Such reputations may deter entry. Finally, the meeting competition defence cannot account for differences in quality, which may enable an incumbent, in effect, to undercut its rivals' prices while technically satisfying the condition of matching their prices. In other words, incumbents go beyond merely meeting the competition when their product is of higher quality than their competitors' products are. It is difficult for courts to take such differences into account. Although such exercises have been attempted, they have the appearance of being arbitrary.

9. *Several lessons about law enforcement methods against predation may be learned from recent cases brought against airlines*

A comparison of recent cases in the airlines industry shows how divided different jurisdictions still are in terms of the cost measures used in their predation analyses. It also shows that the basic framework used in predatory pricing cases can also be applied in predatory capacity expansion cases. Courts still apply price-costs tests, as in predatory pricing cases. Emphasising the capacity expansion aspect of a case may, however, help to focus the court's attention on the incremental segment of output that is allegedly losing money. In other words, characterising the incumbent's behaviour as predatory capacity expansion encourages use of the average avoidable cost test. Finally, some jurisdictions still allow the meeting competition defence in predation cases, while others refuse to apply it.

10. *Not all predatory behaviour involves pricing strategies. Companies may also use "cheap exclusion" tactics to eliminate and deter competition*

Predatory pricing is an expensive way to eliminate competition in comparison to other alternatives that may be available. Cheap exclusion strategies, for example, are capable of inflicting substantial harm on competition even though they cost far less to implement than most predatory pricing campaigns. Such strategies include simple, inexpensive, but often highly effective conduct such as lying to regulatory bodies in ways that disadvantage rivals. A feature of such cheap exclusion is often the effort to use governmental or quasi-governmental authority to create impediments to competition. Alternatively, an incumbent may find it much less expensive to try to raise its rivals' costs than to engage in a predatory pricing strategy. Some cheap exclusionary behaviour, however, is efficiency-enhancing. Exclusive dealing is one possible example. Therefore, agencies should focus only on conduct that has no plausible efficiency enhancing defence.

Predatory Foreclosure

2. Background Note

Background Note

by
Jeremy West*

1. Introduction

Predation is among the most frequently discussed topics in competition law and economics. It has attracted a great deal of attention over the years not only because of some high-profile cases, but because the theoretical issues surrounding predatory conduct have sparked several interesting debates among academics and practitioners alike. Yet, in spite of all that has been written about predatory conduct, some core issues remain unresolved. A multitude of conflicting views remains among different nations concerning how to detect and deter predatory conduct. Even within some jurisdictions, a clear position still has not been adopted by the various courts and competition authorities. This note addresses issues that competition authorities will usually need to consider when trying to distinguish competitively harmful predation from merely aggressive but competitively benign or beneficial conduct. It also compares the advantages and disadvantages of several types of analysis that are currently in use.

Many different varieties of business conduct may be considered potentially “predatory”, but they generally fall into two categories: predatory pricing and non-price predation. When a company pursues a predatory pricing strategy, it offers its goods or services at unrealistically low prices in the short term in order to achieve a longer term objective. More specifically, the company sacrifices profits for some period of time because it believes that by doing so it will drive its rivals out of the market, discipline them, and/or deter entry. It is rational to employ a predatory pricing strategy only when a company expects to acquire or maintain some degree of market power as a result of that strategy. Thus, a general definition is that pricing is predatory when it cannot

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be profitable unless competition is eliminated or at least restrained.¹ Once a predator has acquired or successfully maintained market power, it hopes not only to recoup the losses it sustained during the predatory period, but to enhance profits by holding its prices above the competitive level. Therefore, when a predatory pricing scheme is successful, even though consumers benefit from unrealistically low prices in the short run, they ultimately suffer due to the loss of competition.

The key controversies concerning predatory pricing are 1) what the best measure of cost to use in price-cost tests is; 2) whether to use a recoupment test; 3) whether and when intent evidence is relevant; and 4) whether the meeting competition defence should be allowed. This paper addresses each of those subjects and makes recommendations based on the academic literature and recent jurisprudence.

Non-price predation often involves making excessive investments that have the sole purpose and likely effect of weakening or eliminating competitors. Predatory investments could be made, for example, in extra capacity, product differentiation, or advertising. Furthermore, businesses may adopt strategies designed to raise their rivals' costs. Because predatory pricing cases are more common than non-price predation cases, this note focuses on the former. There has, however, been a flurry of cases brought against airlines in recent years involving allegations not only of predatory pricing, but of predatory capacity expansion and product differentiation, as well. Together, these cases make an excellent laboratory in which to study predatory behaviour. In fact, the airline cases were a primary reason for the Committee's decision to hold a roundtable on predatory foreclosure. Accordingly, one section of the paper is devoted specifically to them.

The key points of this paper are:

- A number of price-cost tests are available to help detect predatory prices. Although the Areeda-Turner test (which relies on average variable cost) has historically been the most widely accepted price-cost test, support appears to be growing for the average avoidable cost test. The latter test can focus solely on the range of a firm's output that is allegedly predatory. It can also take fixed costs into account when they are specifically associated with the capacity expansion that accompanies a predatory campaign.
- Some commentators recommend taking action against incumbent firms that lower their prices in reaction to entry, even when those prices do not go below any measure of the incumbent's cost. At least one major court decision has followed that approach. Other commentators are sharply critical of this idea, noting that its effect on consumer welfare is uncertain at best and that it encourages inefficient entry. Tolerating limit-pricing

strategies seems to be preferable to encouraging higher prices and accommodating inefficient entrants.

- Recoupment is a controversial area in predatory pricing analysis. Depending on the policy objectives behind competition laws, the recoupment test may serve an essential function in predation cases. It helps to sort out which predatory actions are likely to harm competition (as opposed to competitors), and therefore acts as a safeguard of consumer welfare. It may also save agencies and courts from the difficulty that is sometimes encountered in conducting price-cost tests. If objectives other than consumer welfare are important, however, the recoupment test may be less vital.
- A likelihood of recoupment is not necessarily established when a firm is found to be dominant. Several other factors have to be considered, such as the ability to expand capacity, relative financial strength, and reputational effects.
- Another controversial subject is the relevance of intent evidence. There is a difference between general evidence of intent to eliminate a competitor and a specific, detailed plan to absorb losses in the short term for the purpose of eliminating competition and reaping supra-competitive profit in the long term. The former type of evidence is not particularly meaningful because it is commonplace for firms to strive to defeat their rivals in one way or another. The latter type is more helpful because it shows that, at the very least, the alleged predator believed that its plan could succeed. Nevertheless, it may be best to limit the use of such evidence to rebutting defendants' attempts to establish legitimate business justifications for their below-cost prices, as opposed to using intent evidence to establish the *prima-facie* violation.
- Just because a firm is pricing below cost does not necessarily mean its actions are harming competition. There are some circumstances under which such pricing is not only benign, but actually pro-competitive. Agencies should thoroughly investigate any justifications that alleged predators proffer for their pricing.
- One justification that has generated disagreement among jurisdictions is the so-called "meeting competition" defence. Defendants using that defence are arguing that they should not be punished for merely matching a competitor's price, as opposed to undercutting it, and that they have a right to defend themselves against firms who undercut them, even if that means pricing below the defendant's own costs. The relationship between the defendant's price and cost, however, is much more informative than the relationship between its price and someone else's price. A price should not be deemed predatory just because it is below a rival's price. But by the same token, it should not be deemed non-predatory just because it is not below a rival's price. A matching price still has the power to exclude in some

situations, such as when there are differences in the relevant products' quality.

- In addition to having broad abuse-of-dominance statutes, some nations have specific resale-below-cost laws that punish retailers for pricing below their own costs. The elements of proof are much easier to satisfy than the elements under a traditional abuse-of-dominance framework. As a result, these resale-below-cost laws appear to capture pro-competitive conduct and have the effect of keeping prices higher in order to protect smaller, possibly less efficient competitors.
- A comparison of recent cases in the airlines industry shows how deeply divided different jurisdictions are in terms of their predation analyses. It also shows that the basic framework used in predatory pricing cases can also be applicable in predatory capacity expansion cases.

2. Predatory pricing

2.1. *The concept of predatory pricing*

In general, prices are predatory when they are so low that they can be considered rational only because they ultimately eliminate or deter competition, thereby enabling the predator to achieve or maintain some degree of market power. For example, in a classic predatory pricing scenario, an incumbent monopolist reacts to entry by lowering its price to a point at which the entrant is forced to operate at a loss. Under most definitions, a predatory price will force the incumbent to sustain losses, as well. By maintaining its low price for a period of time, the predator strives to damage the entrant to such an extent that it must exit the market. At that point, the predator raises its price to the monopolistic profit-maximising point and collects more than enough profits to compensate for its predatory losses.

There are many variations on that classic scenario. The predator does not necessarily have to be a monopolist, or even a dominant firm, for example. It might, in fact, be an oligopolist. Furthermore, predatory prices may not be aimed at eliminating an existing rival, but rather at deterring entry by potential competitors. Moreover, there is a spectrum of price cuts – usually measured against the predator's costs – that may or may not be considered predatory, depending on the circumstances of each case and the jurisdiction in which it occurs.

Much of the theoretical work on predatory pricing was done during the 1970s, when academics began the long-running debate over the best way to detect it.² During the 1980s, the rising popularity of “Chicago-school” economics largely stifled the debate because that school considered predatory pricing to be so rare and irrational that it was not worthwhile to devote much attention to it.³ That view prevailed until the work of “post-Chicago-school”

academics invigorated support for the position that predatory pricing is neither so irrational nor so rare as had been previously thought, and competition agencies started to bring more predatory pricing cases.

Regardless of whether one believes predatory pricing is rare or not, if a company engages in it successfully, it will damage competition. On the surface, though, it seems odd that competition laws might be used to attack prices on the ground that they are not high enough. After all, the philosophy behind competition laws in general is that they are intended to promote competition, which is supposed to enhance consumer welfare by keeping prices lower than they would be if markets were more concentrated, collusive, or restrictive. Indeed, few consumers ordinarily believe that there is such a thing as a price that is too low. It is true that even successful predatory pricing improves consumer welfare in the short run, since the strategy involves unusually low prices at first. Predation, however, is a dynamic process, and when it succeeds, the resulting higher prices are detrimental to both consumers and allocative efficiency in the long run. If incumbent firms were allowed to absorb losses in order to undercut and eliminate rivals, then the benefits of competition would not be fully realised.

A key difficulty for enforcement agencies is that predatory pricing resembles legitimate competitive behaviour. It can therefore be extremely difficult to distinguish one from the other. A price cut in response to entry or the threat of entry is exactly what one would normally expect from an incumbent that had been enjoying more than a competitive level of profits. Over the years, many different tests have been devised to aid agencies and courts in sorting out predatory behaviour from tough competition. The major tests are described in the next section.

2.2. Tests for detecting predatory pricing

2.2.1. Price-cost tests

The aim of price-cost tests is to discern whether a company is incurring losses that are rational only if they are part of a predatory pricing strategy. By comparing objective cost and price data, these tests do not directly address the more subjective question of whether a company intended to engage in predatory pricing, but rather they provide information about whether it is actually doing so. This objectivity is crucial because *how* an incumbent attacks its rivals is more significant in economic terms than whether it *intended* to do so.

For example, if a firm forces a competitor out of business by pricing such that the competitor must operate at a loss to meet that price, then it may be true that the elimination was intentional, that the firm intended to send a signal to deter potential entrants, and even that it wished to do these things so that it could achieve or maintain a dominant position. If that firm is more

efficient than the competitor was, however, and it was therefore able to accomplish these goals simply by undercutting the competitor's price while continuing to cover its own costs, then the outcome described above is consistent with normal competitive behaviour. On the other hand, if the firm priced below its own costs, then the competitive process was distorted and the firm may have expelled a more efficient competitor from the market.

What qualities are desirable in a price-cost test, then? Ideally, the cost benchmark would be set such that the firm could not possibly price above it and still manage to eliminate or deter competitors and potential competitors that are at least equally efficient.⁴ At the same time, care would have to be taken that the cost benchmark is not too high. "Too high" in this context means a rule that would force businesses to raise prices above the competitive level to avoid violating the law. In that situation, consumers, whose welfare the law is presumably intended to promote, might be paying higher prices than necessary because the law would protect less efficient firms from competition. Moreover, the more efficient firms would be collecting supra-competitive profits.

Most jurisdictions use some type of price-cost test when analysing predatory pricing cases. The agreement largely ends there, however, because different jurisdictions consider different measures of cost to be most appropriate for detecting predatory pricing. Furthermore, some jurisdictions use more than one cost measure, while others have not yet decided what the best measure is.

Cost measures. The following measures are often mentioned as possible cost benchmarks:

- marginal cost ("MC") is the cost of producing the last unit of output;
- average variable cost ("AVC") describes how MC behaves, on average, over a given range of output. AVC is calculated by identifying those costs that vary with output, adding them together, and dividing the result by the total number of units produced;
- average avoidable cost ("AAC") is the sum of all costs that a firm can avoid by not producing a certain quantity of output, divided by the total number of units not produced. The avoidable costs are defined as the variable costs and product-specific fixed, but not sunk, costs that were incurred to produce the given range of output;
- average total cost ("ATC") is calculated by dividing a firm's total costs – variable plus fixed, including common costs – by the total number of units produced. Common costs are fixed costs that support a number of activities or product lines. For example, the salary of a company's receptionist is a common cost. It is an essential position, but no part of the salary is caused by any specific product alone.

The Areeda-Turner test. In a 1975 article that stimulated great interest in predatory pricing, Areeda and Turner introduced what is now the most famous test for predation.⁵ They proposed that a price less than short run marginal cost is predatory, and that any price above that amount is not predatory. The rationale for this test is straightforward: in the theoretical state of perfect competition, market forces will force firms to price at MC. Accordingly, as long as a price is at or above that level, it cannot be deemed too low because that is the level that would prevail in the most competitive kind of market structure. Furthermore, as long as an incumbent's price does not exceed that level, the price cannot exclude a competitor who is at least as efficient as the incumbent.

The authors were well aware that MC data is not easy to find, though. MC is more of a conceptual tool for economists than an easily measurable, empirical reality. Therefore, Areeda and Turner recommended using AVC as a surrogate.

Most of the criticisms levelled at the Areeda-Turner test can be grouped into either of two categories: 1) short run MC is not a good test because even though most prices below it are predatory, some prices above it can be predatory, too; 2) assuming that short run MC is a good test, AVC is often a poor substitute because it tends to fall below MC (and therefore underestimate it) at higher output levels, leading to false negatives when testing for predation.^{6, 7} Another significant criticism is that the AVC standard favours defendants with high fixed and low variable costs, such as firms in the transportation and software sectors. In those industries, it is relatively easy for low prices to remain above AVC. Therefore, using the AVC test might allow incumbents to keep new entrants from recovering their (fixed) capital costs for a very long time, which in turn would deter entry.

Despite the criticisms, the Areeda-Turner test has probably had more worldwide influence on predatory pricing litigation than any other price-cost test has. Many courts and agencies seem to have taken the position that what the test may lack in accuracy is compensated for by the fact that it is relatively easy to use. Furthermore, the test is not without some substantive merit. A price that is persistently below AVC indicates that the firm is not even covering all of its variable costs, let alone its fixed costs. Usually, when a firm is experiencing such losses over time, it shuts down because continuing to operate would create bigger losses than going out of business would. Therefore, a firm that stays in business in those circumstances could be a predator (unless it has a legitimate justification).⁸

The average total cost test. One of the drawbacks to using AVC in a price-cost test is that it fails to detect some forms of below-cost pricing. Not only can it underestimate MC, but it also overlooks prices that are above AVC yet below

ATC. When pricing in that range of its costs, a firm is covering its variable costs but not all of its fixed costs. Therefore, the firm may be failing to charge enough to cover items like rent, interest payments, and depreciation. A price in this range will not inflict losses on an equally efficient competitor to the same extent that a price below AVC would, but holding price below ATC for a lengthy period can still cause financial damage to both the predator and its rival(s).

Consequently, some jurisdictions, such as the European Union, incorporate an ATC test in their predatory pricing analysis. Usually, the test is part of a framework that roughly resembles one first proposed by Joskow and Klevorick.⁹ Those authors favoured a joint AVC-ATC approach in which prices below AVC are always deemed predatory, and prices greater than AVC but less than ATC are deemed predatory unless the defendant has a reasonable justification for the price.

The ATC test is not without drawbacks of its own. First, while it may seem that measuring ATC should be easy, it turns to be difficult – so difficult, in fact, that some economists have argued that accurately measuring ATC for a good sold by a multi-product firm is impossible. The basic problem is that when a firm produces several products, attributing common costs to a single product line is an arbitrary process. As William Baumol has observed,

... Outside a textbook, there probably exists no such thing as a single-product firm, and all multiproduct firms have fixed costs incurred in common on behalf of two or more of their products. There is, however, no economically defensible way of dividing such costs up among the firm's various products. As is well known, all methods for the allocation of common fixed costs are arbitrary.

Before the courts or regulatory agencies, ATC (fully allocated costs) are always manipulated to produce whatever answers are desired by the party that puts them forward. Moreover, as I show elsewhere, the amounts by which these contrived cost figures can easily be manipulated is [sic] enormous. Thus, though to economists it may seem obvious, for practitioners in the antitrust arena it is hardly redundant to suggest [that] any conclusion about the predatory character of a price that is based on a calculation of average total cost must be disregarded.¹⁰

One might be tempted to solve the allocation problem by assigning shares of common costs to the firm's different product lines according to the percentage of overall corporate revenue they each produce. The problem with this easy fix is that sometimes it will be clear in an ordinal sense that one business line uses a source of common costs more than another business line, but it will not be clear how the two compare in a cardinal sense. In other words, one may be able to tell which line is the heavier user, but not by how

much. Thus it may be quite obvious that a relatively low revenue product line is using a certain common resource more heavily than a high revenue product line, but there might be no way to measure the difference. This might be the case with a receptionist's services, for example. If the common cost is nevertheless allocated according to revenue, there will be a clear error in allocation, though it will not be measurable.

Another drawback to the ATC test is that pricing below ATC for some period of time may be a rational response to entry even if its result is not the elimination of competition. For example, after a new firm enters with a low price, an incumbent may experience a decline in demand such that marginal cost pricing allows it to cover its variable, but not all of its fixed, costs. As long as those costs remain fixed, it is rational for the firm to cover at least some of them if it can. In contrast, if it were to hold prices steady at the pre-entry level, the firm might suffer an even greater decline in demand, such that it was not even able to cover its variable costs. The possibility that below-ATC prices are non-predatory does not mean that all of them are, but it has led some well-known academics to conclude that they should be permitted because it is too difficult to sort them out.¹¹

The average avoidable cost test. The use of AAC in price-cost tests has been gaining momentum in recent years.¹² The AAC test is really a variant of the Areeda-Turner test. Under the AAC test, price is compared to the average of variable costs plus product-specific fixed, but not sunk, costs over a given range of output. The objective is to determine how much a firm would save by not producing a range of output.

One advantage of using AAC is that it is a better estimate than AVC of the true cost that a firm incurs when it produces output that is sold at an allegedly predatory price. When a firm increases output in a predatory campaign,¹³ it may have to incur more costs than just those that happen to vary with every unit of output sold, which the AVC test measures. Sometimes a predator will also incur substantial fixed costs when it increases its capacity to absorb extra demand. For example, a baker might have to buy another oven, or a tour guide might have to buy another tour bus. Those kinds of expenses are incurred step-wise, rather than increasing evenly with every additional cake or ticket sold. Thus, it can also be seen that by incorporating product-specific fixed costs, the AAC test blunts the criticism that the Areeda-Turner test is too easy to pass in high fixed-cost industries.

Alternatively, a predator might reallocate a fixed-cost input from one of its other product lines to the line in which it is carrying out its predatory plan. The avoidable cost concept captures that possibility, as well, which is appropriate when that input could have been used profitably where it was.

Another advantage of the AAC test is its flexibility. It can be used to study several dimensions of a firm's pricing. For instance, it could be used to test the pricing of overall output for a product. In that case, the total revenues from sales of that product would be compared with the costs the firm would save if it completely withdrew the product from the market. The AAC test is equally capable of testing the pricing to a subset of customers, in which case revenues from sales of the product to those customers alone would be compared to costs that the firm would have saved by not supplying those customers.¹⁴

Precisely what should be counted as an avoidable cost also depends, in part, on the time period considered. Ordinarily, the longer the time period, the larger the total and average avoidable costs will be. This is true because more and more sunk costs become avoidable costs over time. A contract may expire, for instance, or a buyer may eventually be found for an unusual piece of machinery. It is clear, then, that the AAC test becomes harder and harder to pass as the time period lengthens. The logical time period to consider, in turn, is that in which the allegedly predatory pricing occurred.¹⁵ The AAC test therefore becomes harder and harder to pass the longer the allegedly predatory prices cuts persist.

Above-cost prices. One possibility that has generated considerable debate recently is whether pricing can ever be considered predatory when the alleged predator is not pricing below any measure of its cost, but is nevertheless failing to maximise short-run profit. Essentially, the question is whether limit pricing should be unlawful. When using that strategy, an incumbent sets its price at a profitable level, but below the short-run profit maximising point, choosing a corresponding level of output that leaves just a bit too little residual demand for entry to be profitable (i.e., the entrant would not be able to recover its ATC at the prevailing price). By sacrificing some of its profit, the incumbent keeps entrants out and is able to earn at least some supra-competitive profit. This strategy harms consumer welfare when entrants would have become at least as efficient as the incumbent if they could have gotten a foothold in the market, gained experience and volume, and eventually lowered their operating costs.

To address the harm of limit pricing strategies, Aaron Edlin has proposed that incumbent monopolists should be prevented from responding to entry by cutting price substantially or making significant product enhancements until entrants have had an opportunity to become viable or perhaps even until the monopolist loses its dominant position.¹⁶ Einer Elhauge argued in response that a workable rule to stop above-cost predatory pricing does not exist, and even if it did, it would fail to yield a more competitive outcome.¹⁷

Elhauge gets the better of this argument because Edlin's rule encourages inefficient entry, forcing lower-cost incumbents to accommodate it despite

uncertain results. It can be difficult for competition agencies (or anyone else) to make accurate predictions about whether entrants would have eventually been more efficient and viable. Furthermore, it is uncertain whether consumers are better off with an efficient incumbent who is forced to keep its prices high in the short term in order to encourage possibly inefficient competitors in the long term, who may nevertheless be eliminated, or with lower incumbent prices in the short term that deter entry by any firm that cannot immediately or quickly become as efficient as the incumbent.

In other words, it is hard to predict whether society would be better off with limit prices on goods produced by an efficient incumbent or with lower prices on goods produced by inefficient firms. In fact, it is not even clear that social welfare would be improved by moving from *monopoly* prices set by an efficient incumbent to lower prices set by inefficient producers.¹⁸

Moreover, by making the attainment of a dominant position much less attractive, Edlin's rule would remove some of the incentive for firms to compete vigorously in the first place. In the end, that could be far more harmful to competition, innovation and long-run consumer welfare than a limit-pricing strategy.¹⁹

A significant problem with profit-maximisation tests in general is that determining whether a firm was pricing at the short-run profit maximising level can be very challenging. As one court observed, a profit-maximisation test "would require extensive knowledge of *demand* characteristics – thus adding to its complexity and uncertainty".²⁰ In contrast, from a consumer welfare perspective it is perfectly clear that limit-pricing is preferable to monopoly-level pricing. Thus, in the face of the uncertainties just mentioned, it seems better to allow limit pricing rather than to force monopolists to reduce consumer welfare further by maximising their profits. Consequently, provided the incumbent's price stays above ATC, it is usually permissible to set a price below the short-run profit maximising level even if the motive is purely malicious.²¹

2.2.2. Recoupment

Unlike price-cost tests, the recoupment test is not used to determine whether predatory pricing is actually occurring. Instead, this test assumes that predatory pricing is happening and asks whether it is likely to succeed in light of the characteristics of the relevant market, the predator, and its target(s). Specifically, the recoupment test aims to determine whether a company's predatory pricing campaign would be likely to eliminate and deter competition, and whether it is likely that the predator will then be able to amass at least enough supra-competitive profit to recover the losses it sustained during the attack.²²

The recoupment test is based on the premise that the policy objective of competition law is to promote consumer welfare. If other objectives, such as the preservation of small competitors or minimising market concentration for its own sake, are seen as policy goals or factors contributing to some other (non-economic) type of consumer welfare, then the recoupment test has less importance. However, as a means of helping competition agencies and courts to ensure that they are targeting behaviour likely to harm consumer welfare, and that they do not inadvertently reduce that welfare, the recoupment test is quite valuable.

This point is clarified by considering that the recoupment of predatory losses necessarily involves harm to consumer welfare. Predatory losses can be recovered only by setting and sustaining a price higher than the price that would have been charged if the predatory attack had not eliminated or deterred competition. It is the above-competitive price that harms consumers. Thus, if the recoupment test indicates that there is little or no likelihood of recoupment, then predatory pricing would not only be irrational, it would be unlikely to harm consumer welfare. Indeed, in that case a predatory pricing campaign should actually boost consumer welfare for as long as the predatory attack lasts, with little or no danger of harm to consumers in the longer run. Therefore, under the logic of the recoupment test, even if a company is pricing below cost, when recoupment is implausible the best course of action for the competition agency (and the courts) is to do nothing.

To put it another way, allegedly predatory prices can harm competition only if they cause rivals to exit, discourage them from entering, or discipline them into becoming price followers. That the low prices may be inconvenient to other competitors, or that they might harm competitors, is an insufficient basis to prohibit price cutting because all competitive behaviour inconveniences competitors and “harms” them in one way or another. The recoupment test helps to sort out the prices that are likely to harm not only competitors, but competition itself.

The recoupment test is intended to serve as a threshold inquiry. If it shows that predation is unlikely to eliminate or deter rivals, or that recoupment of losses is ultimately implausible, then this test enables agencies and courts to dismiss allegations of predatory pricing without having to conduct a price-cost test. This is quite useful because the process of determining whether prices are predatory based on their relationship to some measure of cost is often quite difficult.²³ If the test shows that recoupment is likely, however, then it must be used in conjunction with a price-cost test to establish that the alleged predator actually is charging predatory prices.

Before examining the various factors that should be taken into account in a recoupment test, it is important to note that recoupment differs according to

whether the predatory attack was launched against an existing competitor or against an entrant/potential entrant. In the former case, the target is a rival who has been exercising a downward influence on the predator's price. After a successful predatory pricing attack eliminates or disciplines the pricing behaviour of the rival, the predator will raise its price above the pre-predation level. By doing so, it will eventually recover the losses incurred during the predatory period and earn even more, as well. There would, after all, be no reason to undertake this risky strategy if there were not supra-competitive profits to be gained through its success.

In the case of predation against an entrant or potential entrant, the predator lowers its price in order to make entry appear unviable so that the recent entrant exits and/or the potential entrant is deterred. If and when that strategy succeeds, the predator will raise its price back to the pre-predation level. It will not, in all likelihood, try to raise it above that level, for if it could do so profitably, it would have been pricing at that level before the entrant appeared. Thus, in this case, recoupment is not achieved through an ability to reap profits as never before, but through the restoration of a position that provides the previous level of supra-competitive profits.

Recoupment analysis takes into account a variety of conditions that contribute to the likelihood that a predatory pricing strategy will be successful. Not all of the conditions must be present to establish a likelihood of success.

Dominance or market power. Even in jurisdictions that do not use a recoupment test, this condition will probably be considered if for no other reason than that the competition laws in most member countries have a dominance or market power requirement that must be met before unilateral conduct can be deemed unlawful.²⁴ It is not the purpose of this note to explore the different nuances of those thresholds. The important points here are simply that defendants in predatory pricing cases in most member countries must have a dominant position or market power (collectively referred to as "dominance" hereafter), or else be in the process of acquiring it,²⁵ and dominance implies a higher likelihood of recouping predatory losses.

Having a dominant position makes recoupment more likely for a predator in two ways. The first way has to do with the fact that predatory pricing requires both a price decrease and an output increase. Price cutting alone will not work because the objective is to take market share away from rivals. If the predator cannot produce enough extra output to cover what was supplied by those rivals, then market demand at the predatory price will outstrip what the predator is able to supply. Furthermore, even if the predator is the sole producer in a market and is using predatory pricing to deter entry rather than to eliminate competitors, its price cuts will still stimulate additional demand that must be met.²⁶ If the predator cannot produce enough to satisfy both that

additional demand and any demand previously supplied by existing rivals, then existing and potential competitors will not only be able to make sales, but will be able to do so at prices above the level set by the predator. That is exactly what a predator would not want to happen.

Consequently, to produce the necessary additional output, the predator must have excess capacity. This is where it helps to be a dominant firm. The excess capacity required in a predatory campaign against existing rivals varies inversely with the predator's market share, and dominant companies tend to have relatively high market shares. In other words, less excess capacity is required for a predator with a high market share than a predator with a low market share. For example, a predator with 80 per cent of the market will need to expand only moderately to capture its rivals' entire market shares.

In contrast, a firm with only 25 per cent of the market facing three competitors of the same size would have a much more difficult time carrying out a predatory strategy. Putting aside demand elasticity effects, even if the firm doubled its output, it would be able to take only 25 per cent more of the overall market share from the other three firms. That extra amount will most likely come from the three rivals proportionally, rather than from a single one. Consequently, unless this small predator can expand greatly and take over the entire demand previously met by its competitors, its attacking power will be diluted.

Suppose that one of the competitors is so weak that the small predator succeeds in eliminating it from the market. The distributional problem occurs again. The exiting firm's market share will probably not all go to the predator; instead, it will likely be divided among the three remaining firms.

The second reason dominant firms are more likely to be able to recoup predatory losses is that, by definition, such firms operate in markets with entry barriers. As explained in the next section, entry barriers are essential to recoupment.

Barriers to entry and re-entry. Entry and re-entry barriers are part of the analysis of dominance and thus will be considered as a matter of course in nearly all predatory pricing cases. These barriers are essential if a predator is to have any hope of recovering the losses it will incur in a predatory strategy. Once it drives its rivals out, or deters a potential entrant, the predator needs to raise its price high enough to earn the supra-competitive profits that will justify its predatory losses. Ordinarily, those profits attract entrants, which tend to drive prices down to the normal, competitive level. In a market with high entry barriers, though, the predator is shielded from the threat of entry, so it can raise its price without having to worry so much about competition.²⁷

Re-entry barriers are equally important. If it is easy and inexpensive for a defeated rival to regroup and resume its business a few months later, when the would-be predator has raised its price, the predator's recoupment period will probably be short-lived. Re-entry barriers exist, for example, when it is difficult and expensive for a firm that has left the market to repair the damage done to its reputation when it exited. Alternatively, it may be difficult for some firms to rehire the specialists who lost their jobs when the firm went out of business, or to find new ones to replace them.

When considering entry and re-entry barriers in a predation case, competition agencies should pay attention not only to the likelihood of entry, but to the time that will be necessary to accomplish it. If entry is likely but will take several years, for example, then a predatory pricing strategy could still be profitable.

At this point it may seem reasonable to think, because most relevant competition laws have a built-in dominance requirement, which also necessarily calls for an analysis of entry and re-entry barriers, that it does not matter whether there is a separate recoupment test or not. This is not the case, however, because a dominant position and entry barriers alone are not enough to establish that recoupment is likely. Several other structural and behavioural features of the market and its participants have to be weighed.

Relative financial strength. Predatory pricing is a financial war of attrition. To win it, a predator not only has to be financially strong in general, it has to be stronger than its opponents in particular. The more cash reserves a predator has and the cheaper its access to capital is relative to that of its rivals, the more likely it is to survive and succeed in its predatory campaign. On the other hand, if the predator has a weak balance sheet with low cash reserves and it faces relatively expensive terms of credit, and if its rivals are willing and able to invest more money in a price war than the predator is, then the predator is less likely to succeed. In fact, it cannot succeed in those circumstances unless its other costs are lower than its rivals' costs, in which case it probably would not have resorted to predation in the first place.

An interesting feature of predatory pricing is that the closer a firm gets to eliminating its rivals, the more expensive getting rid of them becomes. This point follows from the fact that the predator is losing money, by some measure of cost, on every unit of output it sells. As it takes more and more market share away from its failing competitors, the predator incurs losses on more and more units of output. The predator must have the financial staying power and determination necessary to fund all of its losses and finish the war.

Low price elasticity of demand.²⁸ This characteristic is not essential, but it does make predatory pricing more likely to succeed for two reasons. First, it

reduces the amount of excess capacity required in a predatory attack. In this sense it is similar to dominance or market power, but here the concern is whether the predator can absorb the extra market demand stimulated by its price cuts, rather than whether the firm can satisfy the demand previously supplied by its competitors. The lower the price elasticity of demand, the less excess capacity a predator must have in order to satisfy the new market demand generated by the predatory prices.

Second, a low price elasticity of demand also facilitates recoupment because demand will decline relatively less when the firm raises the market price. A high elasticity of demand, in contrast, would mean that even if the predator succeeded in raising price to a monopoly level, it might lose so much demand that the magnitude of its profits might not be sufficient cover its predatory losses.

Excess capacity. For reasons already mentioned, excess capacity is virtually a prerequisite for a predator. The predator must be able to absorb all of the new demand created by its price cuts, and in the case of predation against existing rivals, the predator must also be able to absorb the rivals' sales. If it cannot do both of those things, demand will exceed the predator's output and prices will have to rise, which will take pressure off of the rivals and allow them to survive, or at least to survive longer.

It is especially noteworthy that dominant firms do not necessarily have excess capacity. If they have little or no excess capacity, and are incapable of acquiring some quickly, then predation is probably implausible. Thus it is not true that recoupment tests are essentially built into the dominance standard that most competition laws have.

One option for a capacity-constrained predator may be to purchase its competitors' assets, if there are any existing competitors. But the more dominant the predator is, the more likely this strategy is to run into difficulty with the competition agency's merger review process. That, in turn, will likely bring unwanted attention to the predatory campaign even if the merger itself would otherwise be permissible.²⁹ Thus, acquiring a rival's assets is not always an attractive option.

Market share trends. Examining market share trends is elementary in recoupment analysis. If the shares did not change during the period of alleged predation, or if the alleged predator actually lost market share during that period, then recoupment would appear to be impossible (or, if the alleged predation is ongoing, recoupment would at least appear to be unlikely). On the other hand, for example, if the alleged predator's market share fell and its rival's share rose prior to the alleged predation, and that trend reversed itself during that period, recoupment would be more plausible.

Brand loyalty. This factor is not essential, but it does increase plausibility. The more brand loyalty the incumbent has, the less costly its predatory campaign will be. This is so because, in order to take sales away from its rivals, the predator will not have to lower its price as far as it would have had to if it enjoyed less brand loyalty.

Relative efficiency. The more efficient the incumbent is relative to its rivals, the less expensive (and thus easier) it will be to conduct a predatory campaign. Conversely, the less efficient the incumbent is relative to its rivals, the more expensive a predatory campaign will be. One might wonder whether an incumbent would ever find it desirable to adopt a predatory pricing strategy if it is relatively efficient compared to its rivals. Information is often imperfect, however. The incumbent may not realize that it has an efficiency advantage. Furthermore, if it is in a hurry to get rid of its rivals, the incumbent may want to speed up the process of wearing its competitor down. Still, an incumbent's efficiency advantage will often be sufficient, in the long run, to vanquish a rival even without resorting to below-cost pricing. Ironically, this means that it is much easier for an incumbent who least needs to adopt a predatory scheme to afford it and make it work than it is for an incumbent who would probably face eventual extinction by a more efficient rival. In fact, the more an incumbent "needs" to predate, the less likely it is to succeed (holding other considerations constant) because it will be necessary to make price cuts that go deeper and deeper below its costs to eliminate its more efficient competitor(s).

Reputational effects. Acquiring a reputation for being willing to absorb losses over time in order to eliminate rivals and discourage potential entrants can significantly increase the likelihood of recoupment for a predator. First, a predatory reputation may have lasting effects on the market in which the predatory attack is carried out. If a firm's predatory pricing strategy succeeds in eliminating rivals, and any potential entrants to that market believe that the predator would employ the same strategy again, the potential entrants will be less likely to enter. As a result, the predator may actually be winning several battles at once when it defeats a rival in the present. Its ability to reap supra-competitive profits may therefore extend farther into the future than would be the case if there were no reputational benefit. This does not mean that reputational effects make recoupment plausible in all predatory pricing schemes. In combination with other factors, however, a convincing reputation as a predator does make recoupment more likely.³⁰

Furthermore, a predatory reputation could be even more helpful to a business that operates in multiple markets. In this situation, the effects of notoriety gained in one market may reverberate throughout the firm's other

markets. The predator may then be able to reap the rewards of predatory pricing in multiple markets while incurring the costs in only one. This is a rather potent theoretical concept because it means that adequate recoupment does not have to come from the market in which the predation occurred. Predatory losses may never be recouped from the market in which they took place, yet because of multi-market reputational effects, the strategy may still be perfectly rational. Note, however, that this scenario depends on the incumbent not having to incur more predatory losses in its other markets because if it did, then those losses would have to be recouped, too.

Reputational effects are not easy to measure, but they can at least be taken into account in a qualitative manner. They are, in fact, showcased prominently in the recent post-Chicago school literature that has helped to revive concerns that predatory pricing can be a sensible strategy.³¹ To date, however, courts have largely ignored or rejected theories based on these effects.³² This may not be very surprising, since the theory's effects are hard to verify quantitatively. Even at a qualitative level, if plaintiffs are allowed to count all of a multi-market defendant's markets as sources of recoupment, it seems that only a very weak case would not pass the test.

Price discrimination. If the incumbent is able to offer its predatory price only to those customers who are seriously considering buying a rival's product, rather than having to implement the predatory price across all of its output, then the cost of the predatory strategy will be minimised, which not only makes it easier to finance but lowers the break-even point in the recoupment process.

Cross-subsidisation. If a firm can fund its predatory losses in one market with supra-competitive profits from another market, then its chances of sustaining predatory prices long enough to eliminate and deter rivals are increased.

2.2.3. *Predatory intent*

One controversial area in predatory pricing analysis is the value of evidence showing that the defendant had predatory intent. Some jurisdictions, such as the European Union, expressly incorporate intent in their predation analysis (along with price-cost tests), whereas others, such as the United States, are more sceptical toward intent as an indicator that predatory conduct is occurring or is likely to harm competition. Proponents of using intent evidence in predation cases tend to support their position by pointing out that business managers, not government agencies or judges, are in the best position to determine whether a predatory pricing scheme would be likely to eliminate competition and ultimately be profitable or not. Since these managers are knowledgeable, rational actors, any evidence showing that they

intended to carry out a predatory plan or harm a competitor is more reliable than guesswork by outsiders about whether recoupment is likely.

On the other side of the fence, opponents of using predatory intent evidence tend to dismiss harsh-sounding language in memos and business plans as indistinguishable from the typical, but innocuous, corporate chest-thumping or cheerleading that is part of good, tough competition:

Firms “intend” to do all the business they can, to crush their rivals if they can... Entrepreneurs who work hardest to cut their prices will do the most damage to their rivals, and they will see good in it... Almost all evidence bearing on “intent” tends to show both greed-driven desire to succeed and glee at a rival’s predicament. Firms need not like their competitors; they need not cheer them on to success; a desire to extinguish one’s rivals is entirely consistent with, often is the motive behind, competition... Intent does not help to separate competition from attempted monopolization and invites juries to penalize hard competition.³³

One possible explanation for the disagreement over intent derives from the fact that some jurisdictions use juries in competition law cases and some do not. As Judge Easterbrook’s quote above suggests, juries may be more susceptible to being misled by intent evidence than judges are. Therefore one might expect that intent evidence would be frowned upon in the United States, where juries are used in some cases, and readily accepted in the European Union, where they are not.

Even where juries are used, and despite the criticism above, when there is evidence of a specific intent to engage in predatory pricing, as opposed to merely general ill will toward competitors, such evidence probably should be weighed, since it shows that at least the defendant itself expected the scheme to work.³⁴ It is submitted, however, that the analysis should not end there. In other words, it should not be enough to prove only predatory intent and below-cost pricing.

Ultimately, the question competition agencies and courts face in competition law cases is whether they should intervene or not. If the correct policy objective is to stop and punish all attempts by dominant firms to engage in predatory pricing, then it makes sense to pursue all dominant firms that fail a price-cost test and an intent test, without specifically considering whether the predatory plan really will work. If the correct policy objective is to promote consumer welfare by protecting competition, however, then there needs to be more assurance that competition will be harmed than just the confident assertions of a defendant who is losing money. In other words, there needs to be a recoupment test.

First, business managers are far from flawless. It is not unusual for business plans to fail. As we will see below in the discussion of the *Aberdeen*

Journals case, companies may believe they can subdue competition with a predatory pricing strategy and yet be completely wrong. The predator could easily have made a mistake about market conditions, the resiliency or sheer resolve of its competitor(s), or its own ability to sustain a money-losing price war. After all, predatory pricing would not be considered such a risky strategy if it were easy to execute.

Second, if the presence of predatory intent is an element of the test for predation, then an absence of proof of such intent suggests that the defendant should be exonerated. This could lead to undesirable outcomes for competition and consumer welfare, since a well-advised company might execute a successful predatory attack without leaving a telltale paper trail.³⁵

Third, allowing liability based on price-cost and intent evidence alone encourages private litigation (where private suits are permitted). It is questionable whether any legitimate policy aim is served by encouraging lawsuits from defeated competitors who believe they were bullied but cannot show any effect on competition.

In any event, if an agency is looking for evidence that an alleged predator intended to adopt a predatory pricing strategy, it will wish to consider the following things:

- *Below-cost price cuts that are targeted toward rivals, as opposed to across-the-board price changes.* For example, if a firm operates in several geographic markets but implements price cuts in the only one in which it faces competition, that behaviour is at least consistent with predatory intent. Alternatively, if it decreases its prices in all its geographic markets, that suggests a more innocuous motive, such as that the firm's costs have declined and it is legitimately adjusting its prices to maximise profits.
- *Attempts to acquire the target company.* If the alleged predator has tried to acquire the target firm in the past, or is trying to do so while the alleged predation is occurring, this may be an indication of predatory intent. Having failed to get rid of its rival through a merger, the predator may be resorting to predation. Alternatively, it may be attempting to weaken the target firm via predatory pricing, so as to drive the acquisition cost down.
- *An unusual history of price movements consistent with predation.* The timing, duration and extent of price cuts by the incumbent may help to establish predatory intent. The typical pattern to look for in the alleged predator's prices is a decrease that lasted long enough to eliminate or deter competition (or is ongoing) and, unless the predatory campaign is still taking place, a price increase back to the pre-predation level (in the case of predation to deter entry) or above that level (in the case of predation to eliminate an established competitor). On the other hand, price histories may reveal that an industry is cyclical, and that the allegedly predatory prices merely reflect

that the bottom of the cycle has been reached. Pricing is seasonal in some industries, for example.

- *Direct evidence of intent.* Obviously, if an investigation turns up documents or testimony indicating that high-level officers within a company purposefully engaged in predatory pricing, this will be helpful in establishing predatory intent.

2.2.4. *Legitimate business justifications*

This topic is related to predatory intent, in a sense, but legitimate business justifications (“LBJs”) are used to exonerate defendants, not condemn them. An LBJ exists when behaviour that otherwise fails predatory pricing tests should be excused because of special circumstances that render the conduct reasonable. No matter what test has been used to detect predatory pricing, the analysis will be incomplete unless it considers any plausible LBJs because there are valid, even pro-competitive reasons why firms occasionally price below cost. “[I]t is hard to imagine a firm that has never found it expedient or even necessary to sell products for at least a brief period at a price below [] cost, for reasons ranging from product introduction to distress sales of products that are perishable or subject to obsolescence.”³⁶

Typically, the burden of establishing an LBJ falls on the alleged predator. To make its case, the company will need to show that it was pricing below cost for legitimate, non-predatory reasons. It must be able to support the conclusion that it would have set the same prices even if doing so would not have harmed competition. Specifically, the company should have to show either that circumstances forced it to price below cost, or that its prices were part of a normal business practice involving a brief period of losses. Furthermore, if the company makes that showing, even critics of predatory intent evidence would probably agree that it is appropriate for an agency to use any such evidence it has to rebut the proffered LBJ.

A wide variety of circumstances may constitute LBJs. The following list is representative, not exhaustive.

Product introductions. Temporary below-cost prices are sometimes nothing more than part of a reasonable effort to break into a market and establish a new brand. Provided the prices do not remain below cost long enough to harm competition, and that the promotional pricing does not occur repeatedly, such pricing is rational even though it is not profit maximising in the short run.³⁷ “Promotional” below-cost pricing by a firm in a market in which it is already dominant, however, should not be permitted.

Promotional pricing is particularly likely to occur in network effects markets,³⁸ where a new entrant must compensate customers for the fact that

it does not yet have a strong network, or pay them for helping to establish one.³⁹ The firm's early investment in attracting customers is recovered over the longer term when the firm has a larger market share. Unfortunately, it will often be difficult to distinguish innocuous below-cost promotional pricing that is necessary to gain viability from predatory pricing that winds up tipping the entire market and eliminating more efficient competitors. In fact, one of the relatively recent developments in economic theory that has helped to turn the tide against Chicago school scepticism about the existence of predatory pricing concerns network effects.

It turns out that predatory below-cost pricing can be shown to be a perfectly rational, profitable strategy in network effects markets, whether the predator is already a monopolist who is fighting off potential entrants, or it is an aspiring monopolist trying to eliminate its competitor(s).⁴⁰ The most famous example is Microsoft's browser war with Netscape, in which Microsoft priced its product at zero (among other tactics) to eliminate Netscape.⁴¹ Not surprisingly, though – and consistent with the concept that there should be an exemption for some promotional pricing behaviour – the theoretical work also shows that below-cost pricing strategies in network effects markets are sometimes welfare-enhancing rather than harmful.

The key point is that in such markets below-cost pricing may be necessary to establish critical mass. In fact, it may be the only way a firm can survive in what will turn out to be a winner-takes-all situation.⁴² Some models show that firms in network effects markets will price below cost even if they face no competitors or potential competitors.⁴³ That means that their behaviour should not be called predatory because it cannot be said that their pricing is rational only because it will eliminate competition. If competition authorities were to intervene against such behaviour, they might thwart network development and thereby harming consumers. Moreover, even if the market did develop, if there are strong network effects then in the end there is likely to be only one winning firm anyway. Taking all of these factors into account, ten Kate and Nielsen conclude that the wisest choice is to let this severe form of competition determine for itself who will survive.⁴⁴

Loss leading. Sometimes a company may price one or more of its products below cost in order to entice customers to buy additional products sold by the company at higher profit margins. This is known as a loss leader strategy. For example, a grocery store may run an advertisement offering orange juice at a price below cost, reasoning that the ad will attract customers who are likely to buy other, higher margin items once they are in the store. Loss leading should be permitted as long as it is not used to destroy a competitor (or potential competitor) who sells only the product that the incumbent is pricing below cost, and thereby to reduce competition in that market.

Systems pricing. This strategy can be an effective way of increasing overall sales and profits when there are demand complementarities among two or more of the company's products. Personal computer printers are often sold at relatively low prices, for instance, when the manufacturers also sell print cartridges that go with them and the margins on the cartridges are much higher. This tactic, called systems pricing, is a form of price discrimination that enables the manufacturer to earn greater revenues from customers who will use the printer more than others and thus are willing to pay more for the cartridges. Price discrimination has indeterminate effects on consumer welfare. A below-cost price on one component of a system may be part of a competitive pricing structure. As with loss leading, if an alleged predator can show that its systems pricing is not being used to destroy a competitor who sells only the product that the incumbent is selling below-cost, and thereby to destroy competition, then systems pricing should be permitted. In any case, systems pricing is ordinarily easy to distinguish from predatory pricing because a genuine systems pricing strategy should remain in effect as long as the products are on the market. In contrast, a predatory pricing strategy usually involves an obvious period of low prices followed by higher, recoupment-level prices on a single component in the system.⁴⁵

Obsolete inventory. Sometimes pricing below cost may be necessary to clear out older products and make room for new stock. In general, this should be permissible.

Industry downturn. Relatively sudden decreases in demand can create excess capacity that may cause firms to price below cost even though they have no intention to engage in predatory pricing. This is the case of a "sick industry". Firms in such markets may decide to stay in business and absorb losses for a while. In doing so, however, they are not looking forward to a period of monopoly-level pricing; they are simply trying to survive in the hope that demand will increase in the future. Over time, if demand does not recover, some firms will leave the market in order to cut their losses, resulting in a realignment of capacity with demand. Thus, below-cost prices in a sick industry are probably not predatory, but are part of the market's normal corrective process.

Cyclical industries. Demand is cyclical in some industries, and firms may need to sell below cost during the slumps to maintain customer relationships, avoid shutdown and re-start costs, and/or storage costs.

Adjustment to a new entrant. Large-scale entry can reduce each incumbent's share of demand rapidly, thereby creating excess capacity and leading to the same situation as an industry downturn.

Learning curves. If there is a steep learning curve for participants in an industry, a firm may decide to hold its price below its present cost in an effort to sell more units and thus work its way down the learning curve more quickly. This behaviour is actually pro-competitive when a learning curve is clearly present and prices are not held below cost long enough to harm competition. If new firms in such industries were not permitted to price below their initial costs, they might never remain competitive long enough to lower their costs and become viable.

The “meeting competition” defence. Whether a dominant firm’s below-cost prices may be excused when they match, rather than undercut, a competitor’s price is yet another controversial topic related to predatory pricing. The “meeting competition” defence (“MC defence”) was developed under US law in the context of discriminatory pricing under the Robinson-Patman Act,⁴⁶ but it has also been applied in Sherman Act predatory pricing cases. In the US, courts have ruled that “[a] company should not be guilty of predatory pricing, regardless of its costs, when it reduces prices to meet lower prices already being charged by its competitors”, and that “to force a company to maintain non-competitive prices would be to turn the antitrust laws on their head.”⁴⁷ More recently, a different US court rejected the idea that the MC defence is available to defendants in Sherman Act cases, setting up a conflict among the circuit courts.⁴⁸

In Europe, the Commission and the Community Courts have not specifically ruled on the MC defence in a predatory pricing case. The ECJ has stated more generally that if a dominant firm is attacked, it may take reasonable and proportionate steps to protect its own commercial interests.⁴⁹ In the United Kingdom, however, Bellamy J. rejected it in a judgment of the Competition Commission Appeal Tribunal, reasoning that dominant firms have a special responsibility not to diminish competition and must protect their commercial interests only by “reasonable and proportionate” means.⁵⁰

In Canada, the defence appears to be accepted. In *Boehringer Ingelheim v Bristol-Meyers Squibb*, the court decided that a below-cost price that merely matches a competitor’s price and goes no lower is non-predatory.⁵¹

From an economic standpoint, the decisions accepting the MC defence do not appear to be well-reasoned. The key question in determining whether a price is predatory has nothing to do with its relationship to competitors’ prices. Instead, the question is whether the price is below the alleged predator’s costs, regardless of whether the price “merely” met a rival’s price.

Suppose a new entrant is more efficient than the incumbent and therefore undercuts the latter’s price. What if the entrant was counting on being able to continue undercutting the incumbent in order to maintain the demand it

needed to operate efficiently? In other words, suppose that the entrant cannot reach its minimum efficient scale unless it has the demand it captures from the incumbent when the incumbent is pricing high enough to cover its own (higher) costs. If the incumbent is permitted to respond by lowering its price below its costs to match the entrant's price, then the entrant will be prevented from gaining the minimum sales volume it needs, and would have had but for the incumbent's below-cost pricing. Society is worse off if the more efficient competitor is forced to exit.

Another logical drawback to the MC defence is that it cannot take differences in quality and reputation into account. Thus, while an incumbent may be matching an entrant's price, it is still doing much more than merely "meeting" the competition if its product is of higher quality or is more trustworthy in the minds of consumers than the unknown entrant's product is. It would be difficult indeed for a court to take such differences into account. Although such exercises have been attempted, they have the appearance of being arbitrary.⁵²

2.3. Approaches to predatory pricing in a sampling of member jurisdictions

2.3.1. European Union

The current approach to predatory pricing in the EU is a blend of price-cost tests and an intent test, based on Article 82's proscription against abuse of a dominant position. The approach was first set forth by the European Court of Justice ("ECJ") in the AKZO decision.⁵³ In that case, the ECJ held that prices below AVC are presumed to be illegal, prices above AVC but below ATC are illegal when coupled with intent to eliminate a competitor, and prices above ATC are conclusively legal.

The holding in AKZO suggests that prices below AVC are always unlawful, leaving no room for a defendant to offer LBJs. 1996's *Tetra Pak II* decision confirms that interpretation.⁵⁴ Later decisions, however, state that the AKZO presumption is rebuttable "by showing that such pricing was not part of a plan to eliminate its competitor".⁵⁵

The European Commission has refined the AKZO approach by issuing a special notice regarding the cost measure that it will use in certain industries.⁵⁶ The notice explains that the AKZO framework may be too lenient in "network" industries, such as telecommunications, in which pricing at the AVC level may still be predatory due to relatively high fixed, common costs among several product lines. The notice states that the Commission will therefore use an average incremental cost measure (similar to average avoidable cost, but including common costs) instead.⁵⁷

A recoupment test is not currently required in the EU. In *Tetra Pak II*, the ECJ ruled that there is no need to prove that an alleged predator had even a “realistic chance” of recouping its losses, let alone a likelihood of doing so. The decision states that “[i]t must be possible to penalise predatory pricing whenever there is a risk that competitors will be eliminated”.⁵⁸ This reasoning contrasts with the rationale behind the recoupment test, and that contrast may reflect different views about the purpose of competition laws. As stated earlier, the recoupment test is grounded on the premise that the primary objective of competition laws is to promote consumer welfare. Under that view, it is of no consequence that a firm’s unilateral conduct may eliminate a competitor so long as the elimination of that competitor does not result in economic harm to consumers. The ECJ’s statement, on the contrary, shows concern for the fate of competitors who may be affected by a dominant firm’s below-cost pricing, regardless of whether their elimination would affect consumer welfare.

That same concern for competitors can be seen in the 1998 *Compagnie Maritime Belge* decision. In that case, the AKZO elements were not met because the defendant was not pricing below ATC. Nevertheless, the ECJ held that under Article 82 it was abusive for a dominant defendant to adopt a strategy of reacting to entry by cutting prices, regardless of whether the prices remained above cost, when 1) the price cuts were reactive and selective; 2) the reduced prices matched the entrant’s prices; 3) the price cuts reduced the defendant’s profits compared to what they would have been at the previous prices; and 4) the defendant’s purpose was to eliminate the entrant.⁵⁹

Significantly, the Court in *Compagnie Maritime Belge* acknowledged the risk that condemning above-cost pricing could shield inefficient rivals from the full effects of legitimate competition. The Court still held, however, that there was abuse in this case because the selective price cuts were aimed at eliminating an entrant and thereby eliminating competition.

It is clear that the ECJ was substantially influenced by the defendant’s intent to eliminate competition. The difficulty with this is that every rational firm aspires to eliminate competition. Every firm would like to be free of competitors and potential competitors so that it can gain a dominant position and reap monopoly profits. There is no certain harm in the mere intention to eliminate a competitor. What matters is how a firm goes about trying to do that. Does it do so in a way that harms consumer welfare in the long run or not?

Einer Elhauge has criticized *Compagnie Maritime Belge* on four grounds. First, attacking above-cost price cuts is unwise because it pays for an uncertain long-term effect (the survival of relatively inefficient firms) with a guaranteed short-term loss (the loss of the defendant’s lower pricing). Restricting such price

cuts may wind up increasing prices and harming consumer welfare in the majority of cases.

Second, restricting selective *above-cost* price cuts will often penalise efficient pricing behaviour. In many markets, incumbent firms can maximise profits and output only by charging more to customers that value the product more highly, thus making them bear a greater proportion of common costs. In such markets, selective discounts to customers on the margin will augment output and welfare. Third, restricting *above-cost* price cuts will reduce the pressure on rivals and potential entrants to become more efficient, which will raise costs and decrease quality for society. Finally, these adverse effects are aggravated by implementation difficulties that are an inevitable consequence of trying to regulate firm pricing, output and responsiveness to entry.⁶⁰

Predatory pricing policy in Europe is at an important point in its evolution. The Commission is currently reviewing its policy on the abuse of dominance – including predatory pricing – to determine how its policy could be made more effective.⁶¹ Meanwhile, the Court of First Instance is due to issue a decision in the *Wanadoo* predatory pricing case, in which the Commission went so far as to “investigated the possibility of recoupment, without using it as a key element in the final decision.”⁶² Furthermore, recoupment analysis is beginning to show up in the Member States’ decisions. In the *State Railways* case, the Swedish Market Court explored the likelihood of recoupment.⁶³ Very recently, in the private *AOL v. Wanadoo* case, the French Competition Council rejected the plaintiff’s predatory pricing claim, noting that although the defendant seemed to be pricing below cost, it was steadily losing market share while several new entrants had gained share, indicating that the market is competitive.⁶⁴

Some commentators have argued that recoupment should be part of the predatory pricing analysis used by the Commission and the European courts.⁶⁵ Their arguments will gain weight if private plaintiffs begin to bring more predatory pricing cases before national courts in Europe. In the US, where the vast majority of predatory pricing claims are brought by private plaintiffs, one function of the recoupment test is to weed out frivolous and abusive claims. In Europe, as long as the Commission brings most of the predatory pricing cases, that problem is not very worrisome. If that changes, however, then the case for a recoupment test will become more formidable.

2.3.2. United Kingdom

The UK has its own competition law, the Competition Act 1998, but the legal analysis of predatory pricing in the UK follows the precedents set by the ECJ in *AKZO* and *Tetra Pak II*. The elements of the UK analysis are therefore the same as those of the EU analysis. The *Aberdeen Journals* decision is an apt

example.⁶⁶ In that case, the publisher of a free, weekly newspaper (“the *Independent*”) complained to OFT that another publisher, Aberdeen Journals, was selling advertising space in its free weekly newspaper at below-cost prices. OFT opened an investigation to determine whether Aberdeen Journals had abused a dominant position.

The Director General of Fair Trading (“DGFT”) found that Aberdeen Journals did have a dominant position in the relevant market. In reaching that conclusion, DGFT conducted an assessment of entry barriers in the newspaper market. DGFT took multi-market reputational effects into account by recognising that an incumbent could raise entry barriers in several of its markets by developing a predatory reputation in one of them. Notably, the defendant publisher was active in several geographic markets.⁶⁷ DGFT’s assessment of dominance was not phrased in terms of recoupment analysis, but it could easily be viewed as contributing to that end. Market power, entry barriers, and reputational effects are all major factors that affect recoupment. They are not, however, the only considerations that should be weighed in a full recoupment analysis.

Next, DGFT determined that Aberdeen Journals had held its prices below ATC, and sometimes below AVC, with a handful of exceptions, for 45 months. It further found that the defendant had intentionally priced below ATC in an effort to eliminate the *Independent*. Aberdeen Journals failed to proffer an objective justification, so DGFT ruled that it had abused its dominant position and, accordingly, imposed a fine.

It is worth pondering what might have happened if the facts of this case had been subjected to a recoupment test. Would it have been adequate that the defendant had a dominant position, that there were high entry barriers, and that it appeared that the defendant could benefit in multiple markets from a predatory reputation earned in one market? The most troubling fact, from a recoupment standpoint, is that after roughly four years of below-cost pricing, the targeted publisher was still in business and had shown no signs of giving up.⁶⁸ Consumers of advertising space were therefore enjoying quite a lengthy period of low prices with no apparent detriment, or danger of detriment, to their long-run welfare.

On the other hand, the finding that the defendant could obtain a strong, multi-market reputation for fighting entry means that further analysis might have solved that problem. The decision’s discussion of reputational effects ended there, though, which was proper given that the analysis was addressing dominance, not recoupment. If it could have been shown, though, that supra-competitive profits would likely have been obtained in other markets as a result of Aberdeen Journals’ predation against the *Independent*, and that those profits would have been large enough to compensate for the defendant’s

predatory losses, then the recoupment test would have been passed. But because that likelihood was neither proved nor disproved, it is not as clear as it could be whether consumers were helped or harmed by the *Aberdeen Journals* decision.

Predatory pricing policy in the UK, like that at the EU level, seems to have arrived at an important node in its evolution. In a recent speech, John Vickers, Chairman of the OFT, stated, in the context of a discussion of a theoretical model in which a ban on selective price cuts would have ambiguous effects on welfare and consumers, that “a rule against selective price cuts could often be bad for consumers in contested markets, and sometimes detrimental to consumers overall”.⁶⁹ Chairman Vickers also noted that the law on abuse of market power in Europe “could now develop in either of two broad directions, with emphasis increasingly either on form or on economic effect”, and he advocated the latter approach.⁷⁰

2.3.3. *New Zealand*

One of the most recent predatory pricing decisions issued by any nation's highest court concerns a case brought in New Zealand. *Carter Holt Harvey Building Products Group Limited v. Commerce Commission* is notable, for purposes of this paper, because it shows that a) the recoupment test is gaining international momentum, and b) the same may be true of the meeting competition defence.⁷¹ The case stemmed from a price war in New Zealand's insulation market. The defendant was a major wood fiber products manufacturer. Its subsidiary, INZCO, responded to the entry of New Wool Products (“NWP”), a manufacturer with a superior, wool-based product, by releasing its own wool-based product. The price of INZCO's new product was higher than NWP's, though, and INZCO continued to lose market share. Eventually, INZCO reduced its price by 50 per cent, sending it below average variable cost. Sales of NWP's product then fell sharply, and it complained to the Commerce Commission.⁷² The Commission filed a lawsuit alleging that the defendant's predatory pricing strategy violated Section 36 of the Commerce Act 1986.⁷³

The Privy Council took no issue with lower court findings that the defendant was in a dominant position and that it implemented its price cut in order to prevent or deter NWP from competing, or to eliminate it. The Council also accepted lower court findings that INZCO priced below its AVC. It held, however, that this was not enough to conclude that INZCO's conduct violated the Commerce Act. There must be evidence that the defendant somehow *used* its dominance for a prohibited purpose, and use – in the context of a predatory pricing case – means price-cutting “with a view to” recouping losses by raising prices without fear of losing market share.⁷⁴

The Privy Council determined that there was no evidence that INZCO's pricing was implemented with a view to being able to charge supra-competitive prices in the future. Its reasoning at this juncture takes a surprising turn. Earlier in its decision, the Council had observed that, in light of other established facts, even if the defendant's predatory pricing strategy had succeeded in eliminating NWP, another wool-based product similar to NWP's probably would have been introduced within a short time.⁷⁵ That fact might have played a larger role in the decision because it seems to show that entry barriers were low and that recoupment was therefore implausible.

Placing its emphasis elsewhere, though, the Council fashioned the equivalent of a meeting competition defence for INZCO. It found that the defendant's pricing "was a response to competition in an area of a market which it dominated but where it had nevertheless been shown to be vulnerable".⁷⁶ The decision continues, "The price level had been set by NWP, and no one could sell a product comparable to [NWP's] at a higher price and be competitive. Without the offer of a comparable product... INZCO was at risk of losing its market share[.]"⁷⁷ Earlier, the decision states that "[t]he obvious response, in a truly competitive market, was to cut the price of [INZCO's product] to a level that was competitive".

In a truly competitive market, INZCO would have eventually been displaced by the more efficient NWP, or else INZCO would have had to improve its own efficiency. Thus, although it may have been an obvious response, it does not seem evident that cutting and sustaining a price below AVC in order to fend off a more efficient rival should be lawful – unless there is no likelihood of recoupment. A disquieting aspect of *Carter Holt Harvey* is that even though it holds that a recoupment test is necessary, it never really addresses the defendant's prospects of recoupment. Instead, the Privy Council ruled that, because the defendant lowered its price to meet the competition of a low-cost entrant, and because the defendant would have continued losing market share if it had not done so, the defendant's actions were merely aimed at preserving its share and were therefore permissible.

It is worth noting that the defendant's below-AVC prices had been in place for seven months when management became aware of the Commission's investigation and altered its pricing. It should also be noted that NWP had ceased production while INZCO's low prices were in effect.⁷⁸ Thus it is not clear from this part of the decision that INZCO could not have eventually elevated its prices back to their pre-entry level, regained its original market share, and thereby recouped its losses.

In any event, the decision is perfectly clear that a recoupment test is required under New Zealand law in predatory pricing cases. In this regard, New Zealand's approach is now consistent with Australia's.

2.3.4. Australia

Australia is another country whose highest court recently issued a predatory pricing decision. In fact, it was the High Court's first statement regarding an allegation of predatory pricing. In *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission*, the High Court ruled that the recoupment test is mandatory. In addition, the decision highlights the anomaly mentioned above⁷⁹ that some competition laws do not seem well-equipped to catch predators who are not dominant at the time they carry out their predatory campaign, but acquire dominance later as a result of their predatory actions. Rather, such laws seem to be effective only when the predator can be said to be able to execute a successful predatory strategy because it was dominant in the first place.

In *Boral*, it was alleged that the defendant had violated Section 46 of the Trade Practices Act 1974 by setting the prices of its concrete masonry products below their avoidable cost of production for 30 months in order to eliminate a more efficient new entrant, C&M. The ACCC argued at an advanced level, contending that Boral recognised that its rival's ability to fund a price war by borrowing in capital markets did not match Boral's own ability to do so, and that Boral desired to benefit from gaining a predatory reputation that would deter entry in the future.

The case turned on whether Boral would be able to recoup its predatory losses once C&M had been eliminated. The trial court had determined that Boral lacked the market power necessary for recoupment because structural barriers to entry in the relevant market were too low. On appeal, the Full Court of the Federal Court accepted the argument that a showing of recoupment was not necessary under Section 46. It is sufficient, that court ruled, to show that a defendant had the ability to price below avoidable costs for an extended period and to eliminate a competitor, regardless of whether the firm also lacked the ability to raise prices high enough to recoup losses. The High Court reversed that decision:

A firm does not possess "substantial market power" if it does not have the power to recoup all or a substantial part of the losses caused by price-cutting by later charging supra-competitive prices. If it cannot successfully raise price to supra-competitive levels after deterring or damaging... competitors by price-cutting, the conclusion is irresistible that it did not have substantial market power at the time it engaged in the price-cutting.⁸⁰

One would like to have seen a phrase such as "or afterward" at the end of that quotation, which would have indicated that Section 46 could capture conduct by a predator who *acquires* substantial market power *as a result of* its predatory behaviour. That was not possible, however, because Section 46 is

predicated on the defendant firm already having substantial market power at the time of the conduct in question. Justice McHugh was well aware of this problem but, unless and until the law is changed, even the High Court cannot solve it.⁸¹

2.3.5. United States

The United States is one of the jurisdictions that have not yet decided which measure of cost is best to use in price-cost tests, at least not at the Supreme Court level. In *Brooke Group Ltd. v. Brown and Williamson Tobacco Corp.*, the Court declined to adopt a specific cost measure and ruled instead that a plaintiff “must prove that the prices complained of are below an appropriate measure of its rival’s costs”. In addition, the Court established the requirement that a predatory pricing plaintiff must prove that there is a dangerous probability that the defendant will recoup “its investment in below-cost prices”.⁸²

Implicit in the Court’s approval of the general concept of using price-cost tests is the rejection of the idea that above-cost prices can ever be deemed predatory. In the Court’s view, predatory pricing requires pricing below the defendant’s costs not because prices at or above cost would necessarily guarantee an absence of anticompetitive pricing, but because that standard leaves intact the crucial role of price-cutting as a legitimate means of competition. In other words, the Court made a compromise, knowing that its ruling would allow some conduct that could have been classified as “predatory” to go unpunished, but deciding that it was more important to ensure that the antitrust laws themselves did not chill reasonable, competitive conduct.

Prohibiting price cuts that result in above-cost pricing would trade a clear, present benefit to consumers for uncertain future benefits, and it is preferable to encourage prices to move closer to efficient, competitive levels, despite some risk that they could have gotten even closer. Of course, that same point could be used to defend below-cost prices, and indeed the Court recognised that, at least in the short term, “[l]ow prices benefit consumers regardless of how those prices are set”.⁸³ But the Court also made the distinction that unlike below-cost pricing, low but above-cost pricing may exclude a competitor simply because of “the lower cost structure of the alleged predator, and so represents competition on the merits”.⁸⁴ Finally, attempting to identify anticompetitive above-cost pricing may be “beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting”.⁸⁵

Regarding recoupment, *Brooke Group* relied on the earlier *Matsushita* decision, which imposed the recoupment requirement on predatory pricing plaintiffs because “[t]he success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator’s

losses and to harvest some additional gain”.⁸⁶ Picking up on that theme, the Court further explained its insistence on proof of a likelihood of recoupment:

Recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation. Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced... [U]nsuccessful predation is in general a boon to consumers.

That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured: it is axiomatic that the antitrust laws were passed for the protection of *competition*, not *competitors*[.]⁸⁷

The scarcity of successful predatory pricing lawsuits in the US, despite the relatively high number of claims brought there, suggests that the current tests in that country may be too harsh. Not only have plaintiffs had a difficult time satisfying the recoupment test, they have also struggled with the Areeda-Turner test. Although the latter test has influenced virtually every American predatory pricing case since the authors wrote their 1975 article, seven years passed before a plaintiff managed to satisfy a court that the test had been met.⁸⁸ Furthermore, since 1993’s *Brooke Group* decision, no predatory pricing claim has been successful. This has been due, in large measure, to the influence of Chicago-school thought. With post-Chicago school scholarship gaining at least a mention in recent decisions, however, plaintiffs’ fortunes may begin to change.⁸⁹

2.3.6. *A pragmatic approach to predatory pricing based on promoting consumer welfare*

In view of the theories, literature, and jurisprudence discussed above, some suggestions may be made about analysing predatory pricing cases.

- *Use average avoidable cost in price-cost tests.* As is already widely agreed, there should be a price-cost test. Its purpose should be to determine whether an alleged predator is pricing in a manner that could enable it to exclude an equally or more efficient competitor. Average avoidable cost is the predatory pricing benchmark of choice for most economists today.⁹⁰ For that reason, as well as reasons discussed above, it is the recommended measure here, as well.
- *Use a recoupment test.* In light of Australia’s *Boral* decision, New Zealand’s *Carter Holt Harvey* decision, established US law, and early indications that recoupment may become a more frequent part of the European Commission’s analysis, there already seems to be an international trend in favour of the recoupment test. In fact, the trend appears to be substantially

stronger today than it was in 2000, when scholars first began to notice it.⁹¹ For reasons already discussed, it is also recommended here.

- *Consider legitimate business justifications.* It should be possible for a defendant who fails the price-cost and recoupment tests to escape condemnation if it can establish that there were special circumstances that render its pricing reasonable. A proffered justification can be legitimate only if the firm would have set the same prices even if doing so would not have harmed competition. Therefore, the company should have to show either that circumstances forced it to price below cost, or that its prices were part of a normal business practice involving only a brief period of losses. If competition agencies have contrary evidence showing that the defendant's intent was actually predatory, then the agencies should use that evidence in rebuttal.
- *Do not recognise the "meeting competition" defence.* The meeting competition defence is neither economically sound nor workable in practice without being arbitrary. It should not be allowed. Instead, the agency's inquiry should focus on the relationship between the defendant's own prices and costs.

2.4. Resale-below-cost laws

Having reviewed the basic theory and some of the law on predatory pricing, it is appropriate to address the specialised laws on below-cost retail pricing that some countries have. These laws do not replace, but rather coexist with the more general competition law governing the abuse of a dominant position. The resale-below-cost statutes do not necessarily require other elements of proof (besides a retail price below the overall wholesale costs paid by the retailer), such as evidence of a dominant position or predatory intent, though some do. For example, Germany's Act Against Restraints of Competition ("AARC") prohibits a business with "superior market power in relation to small and medium-sized competitors from offering goods or services not merely occasionally below its cost price, unless there is an objective justification".⁹² This provision seems at least to resemble the analysis in certain predatory pricing frameworks, given that it considers the relationship of price to cost, the degree of the defendant's market power, and possible justifications. As it has been applied, however, the AARC is even stricter than the stern predatory pricing standards used in Article 82 cases.

In December 2002, the German Supreme Court ruled that retailer Wal-Mart had violated the AARC by setting the price of certain food items below its purchase cost. Wal-Mart was involved in a price war with two major competitors. Eventually, Wal-Mart lowered its price on sugar below its purchase cost. It also held its milk prices steady despite a sudden spike that pushed costs above those prices.

First, the Court held that under the AARC, it did not matter whether there was any harmful effect on competition. The Act requires only that the defendant have “superior” market power, that it priced below cost, and that there be no objective justification. The Court then determined that Wal-Mart had the superior market power required by the AARC. Superior market power in relation to small and medium-sized competitors, however, is very different from dominance. The AARC does not inquire whether a defendant has superior market power in relation to large, established competitors, two of which Wal-Mart was confronting. That latter fact alone would probably prevent Wal-Mart from being considered dominant, and thus would put its pricing beyond the reach of Article 82.

Finding that Wal-Mart’s prices were indeed below its cost, and that there were no objective justifications, the Court upheld an earlier decision ordering Wal-Mart to increase its prices so as to avoid driving smaller shops out of business.

It is difficult to rationalise this decision on consumer welfare grounds since there was no finding that competition was harmed or likely to be harmed. The Court very clearly based its decision on the finding that Wal-Mart’s conduct might have harmed smaller competitors. The policy objective of the AARC therefore seems to be to insulate small competitors from the effects of below-cost pricing, even if harm to small competitors would not necessarily mean harm to competition, and even if the below-cost pricing was therefore beneficial to consumers.

Title IV of France’s competition law contains even stronger controls on below-cost retail pricing than the AARC does. Title IV nominally concerns “transparency, practices that restrict competition, and other prohibited practices”. Like Germany’s law, however, it is closer to a fair dealing statute because it addresses practices that do not necessarily harm competition in order to protect small businesses. One provision imposes penalties for setting retail prices below purchase cost, which is defined as invoice price plus taxes and transport costs.⁹³ There is no need to show superior market power, dominance, any likelihood of exclusion, or any effect on competition whatsoever. There are exceptions for changes in season, style, or upstream price levels. Small resellers are allowed to meet the price of another seller in the same area, but only if the other seller’s price is legal. Furthermore, prices may be cut for food products that are about to spoil, but the lower price cannot be advertised outside the store. Again, it is difficult to justify this law on consumer welfare grounds because it prevents consumers from enjoying certain low prices even when those prices would not have damaged competition.

Another example is Ireland's Restrictive Practices (Groceries) Order of 1987, which prohibits selling groceries at prices below the net invoice prices paid for the goods. Like its counterpart in France, this law does not consider any market structure conditions or effects on competition. The Irish Competition Authority has spoken out in favour of repealing the Act, arguing that it prohibits legitimate loss-leading behaviour and that it enables upstream distributors to set minimum resale prices downstream. As of this writing, however, the Order remains in effect.⁹⁴

3. Predatory foreclosure in the airline industry

There were five different airline predation cases around the world in 2002 and 2003.⁹⁵ Each of them involved very similar allegations of predatory conduct: an incumbent, confronted with an entrant offering lower fares, lowered its own fares and increased its capacity in an effort to eliminate or discipline the entrant. The outcomes of these cases, however, differed markedly. This makes the 2003 airline cases quite useful for studying the implications of several different approaches to predation.

3.1. The American Airlines case

In *United States v. AMR Corp.*, the government alleged that American Airlines ("AA") had violated the Sherman Act by expanding its capacity on routes that low cost carriers ("LCCs") had entered, such that the incremental costs incurred in the expansion were not covered by the incremental revenue it added. Summary judgment for AA was affirmed on appeal on the bases that the government had not presented valid measures of incremental cost, and AA had not priced below its route-wide average variable costs.⁹⁶ The case is significant because the court a) treated a predatory capacity expansion claim in exactly the same manner as a predatory pricing claim; b) was willing to consider newer theories about the appropriate costs to use in price-cost tests, even though it found that those costs were not correctly calculated in this case; and c) refused to apply the meeting competition defence.

AA carried about 70 per cent of domestic passengers at Dallas/Fort Worth International Airport ("DFW"), one of its biggest hubs. LCCs, who generally have lower costs than the major carriers, had begun to make inroads on some routes departing from or arriving at DFW by undercutting AA's fares. At first, AA responded to these entrants by matching their fares on a limited number of seats. But when it began to sense that an LCC might be winning enough business to form a hub of its own at DFW, AA targeted the LCC's route, adding many more fare-matching seats by bringing in more planes – and in some cases larger planes – from other routes in AA's system. AA's CEO knew this strategy "would definitely be very expensive in terms of AA's short term

profitability[.] If you are not going to get them out then no point to diminish profit".⁹⁷

By pursuing its capacity-expanding strategy on certain routes, AA ignored its own planning models, which had previously shown that such a plan would be unprofitable. In each case, the evidence showed, the competing LCC was unable to establish a presence, opted to move its operations, or ceased operating altogether. Once the competitor was no longer a threat, AA returned to its former strategy by reducing capacity and raising fare prices until they were comparable to the former levels.⁹⁸

The government's argument focused on the exclusionary effect of AA's capacity expansion rather than its pricing per se. Essentially, what allegedly killed competition was not just that AA matched the entrants' fares, but that AA inundated the market with available seats at those fares. Facing so much oversupply in the affected routes, the LCC's lost volume and consequently could not survive.

Furthermore, what made the inundation unlawful, according to the government, was that it cost AA more than it generated in revenue, and it was rational only because AA expected it to eliminate competition, thereby enabling AA to recover its losses later. That recoupment was plausible because AA hoped to benefit from a predatory reputation not only on the routes where it had added the excess capacity, but on other routes where its predatory reputation would deter competition.

The government's description of AA's money-losing plan was crafted so as to discourage application of the Areeda-Turner test, which would have compared all of the variable costs (and none of the fixed costs) with all of the revenues across the entire supply of seats on the routes in question. Instead, the government wanted the court to compare the costs and revenues that were associated only with the incremental capacity that AA added on those routes as part of its allegedly predatory strategy. In other words, the government wanted to use an avoidable cost test.⁹⁹

The district court was not prepared to take that unfamiliar step, so it chose to apply the Areeda-Turner test over the entirety of AA's operations on the relevant routes. Under that test, it found AA's actions to be lawful and granted summary judgment for AA.¹⁰⁰

The appellate court was unreceptive to the government's attempt to focus on the illegality of AA's capacity expansion, as opposed to its price cuts. It held that "prices and productive output are two sides of the same coin", and that "these actions must be analyzed in terms of their effect on price and cost. Thus, ... the government must meet the standards of proof for predatory pricing cases established in *Brooke Group*".¹⁰¹ However, the court did open a new door for the government by holding that AVC is not the only possible

appropriate measure of cost in all cases. It then turned its attention to four incremental cost measures proposed by the government without criticising the general concept of using an incremental cost measure. This suggested – but did not state outright – that the court found the principle of examining only the allegedly predatory range of output to be acceptable.

At this point things began to go badly for the plaintiff, as the court proceeded to find flaws in each of the four proposed incremental cost measures. Each of them was based on data from AA's own accounting system. In a nutshell, two of the tests used cost accounts that allocated 97 to 99 per cent of AA's total costs down to the individual flight level. These were rejected on the basis that they included some costs that would not have been avoidable even if AA had abandoned the entire route. The other two tests used cost accounts that allocated only 72 per cent of AA's total costs down to the flight level. One was rejected because it amounted to a short-run profit maximisation test. The other was rejected because it contained four arbitrarily allocated variable common costs that the appeals court apparently found on its own, without the help of either the defendant or the trial court.¹⁰²

Clearly, it made no difference to the appeals court that AA had relied on the cost measures in its accounting system to make strategic decisions. What mattered to the court was simply whether the government's proposed cost measures accurately reflected average avoidable cost.¹⁰³ Finding that none of them did, it relied on the uncontested evidence that AA's prices never fell below AVC and therefore affirmed the trial court's order granting summary judgment.

There was one other bright spot for the government. The district court had ruled that even if AA had priced below cost, it would still have granted summary judgment because AA had merely met the prices of its competitors, not undercut them. The appellate court disapproved that ruling, deciding instead that the meeting competition defence is inapplicable in the context of a monopolisation claim.¹⁰⁴

Intuitively, the outcome in AMR seems misguided from an enforcement perspective. AMR had a roughly 70 per cent market share in the relevant market. It lost money by adopting a plan that had no chance of being profitable unless it eventually eliminated entrants, and it did eliminate them even though they were more efficient than AMR. Finally, AMR raised its price and reduced its capacity after its rivals exited. Yet, in the end, the fact that AMR's conduct never resulted in a price below AMR's overall AVC enabled it to prevail. This case exemplifies the level of difficulty that exists in bringing a successful predation case in the US today.

On the positive side, AMR shows that at least one appellate court in the US is willing to consider newer thinking on predation analysis. The court

acknowledged that “recent scholarship” has shown that predation can be profitable, “especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets”. Furthermore, the court’s careful attention to the AAC test suggests that it might have validated the government’s claim if there had not been a quirky problem with the cost data.

There was no such problem in the next case.

3.2. The Air Canada case

Canada has taken an unusually precise legislative approach to predation in the airlines industry. Special regulations (the “Airline Regulations”) were adopted in 2000 because of concerns about Air Canada’s ability to abuse market power when it became, by far, the largest domestic airline due to its acquisition of Canadian Airlines. The new regulations made it unlawful for an airlines company to operate or increase capacity at fares that do not cover the avoidable cost of providing the service.¹⁰⁵

In *Commissioner of Competition v. Air Canada*, Canada’s Competition Tribunal was called upon to decide whether Air Canada had violated the Airline Regulations and Section 79 of the Competition Act by engaging in behaviour virtually identical to the conduct at issue in the AMR case.¹⁰⁶ It was alleged that Air Canada had responded to the entry of two LCCs on some routes with a blended strategy of matching the entrants’ fares and increasing capacity in a manner that did not cover the avoidable cost of operations on the affected routes. The Tribunal split the proceedings into two phases and so far has ruled only on the issue of whether Air Canada failed the AAC test on two sample routes.¹⁰⁷

First, the Tribunal held that the appropriate increment of output to examine in the avoidable cost test is an individual, one-way flight, as opposed to examining an entire route.¹⁰⁸ This is the same approach that the plaintiff in AMR was advocating.

The Tribunal also held that avoidable costs consist of the variable costs, and the product-specific fixed costs that are not sunk, which can be avoided by not producing the good or service in question.¹⁰⁹ In identifying which costs are avoidable, the issue of redeployment opportunities came up. Essentially, the question is whether the fact that a resource could have been profitably redeployed to another flight following the cancellation of a given flight renders any of the costs associated with that resource avoidable. For example, if the aircraft, pilots and flight crew on a cancelled flight can be profitably reallocated to other flights (including newly scheduled ones), then are their wages avoidable?¹¹⁰ After finding that Air Canada has many such opportunities for profitable

redployment of its resources, the Tribunal answered that question in the affirmative.¹¹¹

The government took the position that all of Air Canada's costs, except those that can be characterised as overhead, are avoidable within a time frame of three months. It also took the position that income known as the "beyond contribution" or as "follow-on" revenues should not be included in the calculation of Air Canada's revenues for purposes of comparing them with avoidable costs.¹¹² Instead, according to the government, such income could be considered in a later analysis of legitimate business justifications. The Tribunal agreed with both positions, though it shortened the time frame to one month.¹¹³ By agreeing to include all of the non-overhead costs, the Tribunal seems to have taken a different approach from that of the AMR court, which rejected one of the plaintiff's proposed tests because it included arbitrarily allocated common costs.

The beyond contribution is a means of taking into account the demand complementarities present in the hub and spoke systems used by major airlines. A passenger may buy a ticket, for example, that takes her from A to C via Hub B, where she switches onto a different aircraft. She has paid only one fare, but there are two routes on her trip. Flying from A to Hub B is a way for the airlines company to consolidate traffic and offer service to C. In other words, if it were not for the company's ability to provide a flight from A to B, it might never have been able to attract a passenger going to C because there might not be enough volume for the company to justify direct flights from A to C. Thus, a measure of the conceptual profit from the B to C flight is attributed to the A to B flight (and vice-versa).¹¹⁴

Ultimately, the Tribunal found that Air Canada had operated or increased capacity at fares that did not cover its avoidable costs on two routes.¹¹⁵ It will be interesting to see whether the avoidable cost measure gains acceptance by Canadian courts in predation cases arising in other industries, as well.

3.3. The *Germania* case

The analysis in this case was completely different from those used in AMR and *Air Canada*, and shows a more activist posture by both the competition agency and the courts. The *Germania* decision reflects an uncommon willingness to force incumbents to make room for entrants and to dictate the terms of that accommodation with precision.

When *Germania Fluggesellschaft mbH* ("Germania") entered one of Lufthansa's routes with a much lower one-way fare of 99 euros, Lufthansa responded with a 100 euro economy fare, which it eventually raised to about 105 euros. Unlike American Airlines and Air Canada, Lufthansa did not raise its capacity. After reviewing a complaint from Germania, the Federal Cartel

Office (“FCO”) concluded that Lufthansa had abused its dominant position because its economy fare did not cover its average total costs. Later, the Düsseldorf Court of Appeals affirmed.¹¹⁶

When it calculated Lufthansa’s ATC, the FCO included foregone revenues as a cost component. The interesting thing about this step is that the foregone revenues were calculated based on the theory that by offering a reduced fare, Lufthansa was losing money because some passengers who would have paid the higher fare would now prefer the economy fare. This concept is quite different from the foregone opportunities that were considered in the *Air Canada* decision, which concerned the prospect of deploying resources more profitably on other routes. Under the *Germania* approach, Lufthansa was penalised for failing to charge all that the market would bear. Furthermore, this method appears to have a double-counting effect against the defendant. Not only were revenues reduced when customers who would have paid full fares paid economy fares instead, but the FCO increased its approximation of the defendant’s cost by the same amount, as well.

The FCO concluded that *Germania* needed to take some passengers away from Lufthansa in order to survive. It further concluded that Lufthansa’s nearly matching fare, in combination with its superior quality (in the form of frequent flier miles, free newspapers, and higher flight frequencies, reputation, etc.), was preventing *Germania* from doing that. In other words, even though Lufthansa’s fare was slightly higher, in effect it was still undercutting the new entrant.

The FCO then implemented a remedy designed to ensure that *Germania* was able to compete. Monetary values were assigned to each of Lufthansa’s differentiated services, based on the perceived value of those services to customers, not on their actual costs. Ultimately, the FCO decided that, in order to be comparable to Lufthansa’s offering, the *Germania* flight had to cost 35 euros less. It therefore ordered Lufthansa to keep its fares at least 35 euros above *Germania*’s, up to a maximum of 134 euros each way, for two years.

On appeal, Lufthansa relied heavily on the meeting competition defence, and the Düsseldorf Court of Appeals agreed that it is applicable in abuse of dominance cases. Nevertheless, it ruled that in this case, despite the fact that Lufthansa’s fares were nominally higher than *Germania*’s, the defence could not be claimed. The court agreed with the FCO that when Lufthansa’s differentiated services were taken into account, Lufthansa had actually undercut *Germania*’s fare. The Court of Appeals also approved of the remedial concept of quantifying Lufthansa’s higher quality, but was not satisfied with the FCO’s calculation. It therefore adjusted the differential figure from 35 euros to 30.5 euros.¹¹⁷

This decision suggests that the FCO and the Court of Appeals were following a policy based on the principle that more competitors are always better for competition, regardless of the means taken to ensure their survival. By using the most aggressive of all cost measures (ATC) in its price-cost test, counting price cuts as opportunity costs, and assigning values to differentiated services,¹¹⁸ the *Germania* analysis makes it difficult for incumbents to do anything other than accommodate entrants, regardless of whether they are more efficient. Moreover, by pegging the remedy to *Germania*'s entry price without inquiring whether it could have been profitably lowered (and still covered *Germania*'s costs), consumer welfare could be harmed. Other LCCs, with this analysis in mind, could enter other routes at prices well above their own costs, but below Lufthansa's, in the hope that they will be similarly shielded from Lufthansa's competition.

3.4. The Spirit Airlines case

This decision is noteworthy because it used the more conventional AVC test rather than the AAC test, and because it refused to allow the meeting competition defence. Mirroring the allegations in *AMR* and *Air Canada*, Spirit Airlines sued Northwest Airlines, alleging predatory capacity expansion and pricing on two routes involving Northwest's hub in Detroit.¹¹⁹ Spirit, an LCC, had begun service on the two routes by undercutting Northwest's fares. The latter responded by adding new capacity and matching Spirit's low fares on a number of seats. Subsequently, Spirit exited the routes, whereupon Northwest reduced its capacity and raised its fares.

One of the defences Northwest claimed was the meeting competition defence. The court soundly rejected it on the basis that it would allow a predator to price below its own costs in order to match a rival, even if the rival were more efficient and pricing at what was, for it, a profitable level. Therefore, the court reasoned, to allow the defence would be to allow exactly the kind of predatory conduct that the law aims to prevent. Furthermore, in contrast to *Germania*, the *Spirit Airlines* court had no confidence in its ability to determine whether Northwest had really "matched" Spirit's fares or not, given the differentiation between services offered by the two airlines.

Nevertheless, the court granted summary judgment to Northwest. Deeming AVC to be the most appropriate measure of cost, it found that there had been only one month in which the defendant did not pass that test – even when Northwest's "beyond contribution" revenues were not taken into account. Yet there is something unsatisfying about this analysis.

By adopting the AVC test, the court had reduced plaintiff's chances of success substantially compared to what they would have been under the AAC test. First, the court was comparing Northwest's route-wide revenues and

costs, rather than just the incremental figures related to the flights Northwest had added. If Northwest was flying relatively more empty seats on the newly added flights, then performing the price-cost calculation across all of its flights on the relevant routes may have helped it to disguise losses it was incurring on the added flights alone. Second, by using AVC rather than AAC, the court was not taking any product-specific fixed costs into account. Thus, the AVC test may have been comparing higher revenues and lower costs than the AAC test, which naturally works to the disadvantage of the plaintiff.

3.5. Lessons from the airlines cases

There are a few observations that can be made based on this review of the airlines cases. First, different jurisdictions remain divided about which cost measure to use. There is sometimes no clear standard of choice even within a jurisdiction, as illustrated by the different tests considered in the US cases *AMR* and *Spirit Airlines*.

Second, casting a complaint in terms of “predatory capacity expansion” rather than predatory pricing does not change the basic framework of analysis. Courts still apply price-costs tests as in a predatory pricing case. Emphasizing the capacity expanding aspect of the defendant’s strategy may, however, help to focus the court’s attention on the incremental segment of output that is allegedly losing money. In other words, characterising the incumbent’s behaviour as predatory capacity expansion encourages the use of the AAC test. That test helps to prevent predators from hiding their predatory conduct in the route-wide averages measured in AVC and ATC, which take into account the more profitable segment of output that existed before the allegedly unprofitable capacity expansion. There is no reason this approach could not, or should not, be used in predation cases in other industries.

Third, the AAC test seems conceptually sound, but a consensus has not been reached on what costs are avoidable and what costs are not. That much is clear from a comparison of *AMR* and *Air Canada*. Similarly, there does not appear to be a common view yet on whether beyond contribution revenues should be considered.

Finally, some jurisdictions still allow the meeting competition defence in predation cases, while others have seen through it and refuse to apply it.

4. Other forms of non-price predation

4.1. Introduction

There is quite a large variety of conduct that could be labelled “non-price predation”, including bundling, tying, refusals to deal, refusals to license intellectual property, predatory innovation, pre-emptive investments, etc. Covering all of those subjects comprehensively in a note that also strives to

provide a thorough background on predatory pricing is not practicable. Instead, this paper has singled out predatory capacity-building because that conduct figured prominently in the airlines cases. In that context, the analysis turned out to be much the same as it is for predatory pricing. To provide a sense of the nature of other types of non-price predation conduct, a few additional subjects are discussed briefly here. It is suggested, though, that non-price predation should be addressed in a future roundtable if the subject generates sufficient interest.

4.2. Raising rivals' costs

Raising rivals' costs ("RRC") is a powerful form of non-price predation, but it did not receive much attention in economics literature until the early 1980s. A predator employing an RRC strategy attempts to disadvantage its competitors by increasing their costs. Sometimes the predator will have to increase its own costs in order to execute this strategy, but not always. The strategy will be profitable if the predator succeeds in raising the market price by more than it raises its own average total cost (assuming a steady level of output).¹²⁰

RRC is usually a more appealing strategy than predatory pricing because RRC can inflict damage on a competitor without necessarily requiring that the incumbent incur losses itself. Furthermore, the recoupment phase occurs at roughly the same time the RRC strategy is put into effect, rather than at some uncertain point in the future. For these reasons, some commentators have stated that "the RRC analyses... make clear that cost-raising and exclusionary strategies should be the predominant antitrust concern about a dominant firm's behaviour".¹²¹ On the other hand, RRC is not always an available option, whereas anyone can at least attempt a predatory pricing strategy.

Like predatory pricing, RRC is not necessarily harmful from a consumer welfare standpoint. It harms competition only if it enables the predator to charge a supra-competitive price. But unlike predatory pricing, RRC does not lend itself to intuitively obvious methods for detecting competitive harm, such as price-cost and recoupment tests. Some competition authorities have specific guidelines that cover conduct involving raising rivals' costs. Canada's Competition Bureau, for example, has given notice that it will view an act by a dominant firm as an abuse if that act raises rivals' costs or reduces rivals' revenues for a predatory, exclusionary, or disciplinary purpose.¹²² There is, however, no specific process in the Canadian guidelines for ascertaining whether there has been (or will likely be) any harmful competitive effects from the dominant firm's RRC strategy. Instead, there are many examples of RRC strategies that would be viewed as anti-competitive acts. Unless and until there is a consensus among economists on a general test for detecting harmful RRC strategies, Canada's approach seems advisable.

The Chicago School view of RRC has a familiar, sceptical ring to it. Frank Easterbrook has recommended that “for the foreseeable future we leave raising rivals’ costs to the academy”.¹²³ For now, it remains to be seen whether the post-Chicago academics will counter with a basis for greater concern.

4.3. Exploiting information asymmetry

Sometimes the incumbent in a market has an informational advantage over potential entrants due to its greater experience and established contacts with suppliers and customers. This advantage flows in two directions, i.e., the incumbent might not only have better access to market information, but it might also be viewed as a more reliable source of information than newcomers are. This creates the potential for incumbents to create fear, uncertainty and doubt in the minds of others – including potential entrants, customers, and investors or creditors – regarding the feasibility of profitable entry. For example, an incumbent might send misleading signals about market demand and its own costs to deter competitors or make it harder for them to raise capital.¹²⁴ In addition, an incumbent might spread doubt among customers about an entrant’s viability or quality.

In other instances, dominant firms might make misleading product announcements designed to make customers think that they, too, will soon introduce a new type or version of a product that a rival is about to bring to the market. That may have the effect of causing customers to wait for the incumbent’s product rather than take a chance on a lesser-known entrant’s product. Economists have demonstrated how such announcements can damage competition and reduce welfare.¹²⁵

Product announcements were challenged in several older cases that collectively illustrate the challenges that an agency would face in trying to develop guidelines in this area. In some cases, the plaintiff complained that an announcement violated antitrust laws because it was made too far in advance of the actual release of the new product.¹²⁶ In others, plaintiffs complained because the announcements were not made far enough in advance of the product release.¹²⁷ The courts were being asked, in effect, to define the permissible time period in which companies may announce their new products. Drawing a parallel to predatory pricing analysis, a court would somehow have to decide whether the timing of the announcement would have differed if the defendant had believed there was no possibility of harming competition by making the announcement at that time (or at all).

Unfortunately, firms choose the timing of their product announcements for all sorts of plausible reasons, some of which may be competitive and some of which may not. Furthermore, some of the reasons will push the firm to announce earlier, and some will influence the firm in the opposite direction.

For example, it is possible that, by announcing a product early, an incumbent intends to damage an entrant by encouraging buyers to wait until the incumbent's new model is released. At the same time, the incumbent may simply wish to alert companies who produce complementary goods far enough in advance for them to develop new products that work with the incumbent's product. Or the incumbent may wish to keep its new product a secret for as long as possible because it wants to produce and sell all the complementary goods itself. Such conflicting possibilities have led some scholars to give up on a rule and conclude that any timing of a product announcement should be presumed lawful.¹²⁸

5. Conclusion

Current economic theory, if not actual corporate behaviour, leaves little reason to believe any longer that predation rarely or never occurs. It is a serious threat to competition and consumer welfare that warrants scrutiny from competition agencies and courts, albeit very cautious scrutiny. Even though scholars have advanced the discourse over the past several years, they have yet to devise a generally applicable, simple set of rules that distinguishes harmful predation from legitimate competition. Unless agencies proceed quite carefully when considering possibly predatory conduct, therefore, they may inadvertently discourage welfare-enhancing competitive behaviour.

This paper has sought to clarify the basics of the ongoing debate on predation, to describe recent trends in enforcement approaches around the world, and to make recommendations as to what presently seem to be the most sensible ways to test for predation under the premise that competition laws are intended to promote and protect consumer welfare.

Notes

1. See Janusz Ordover and Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation", 91 *Yale Law Journal* 8, 9 (1981) ("although a practice may cause a rival's exit, it is predatory only if the practice would not be profitable without the additional monopoly power resulting from that exit"). Causing a rival to exit is not essential for predation to work, however. If the predatory episode simply beats a competitor into a more submissive position in which it follows the predator's pricing, the latter firm can still achieve its goals. In fact, this outcome may be preferable to forcing the competitor to exit because in that situation, the competitor's assets might be sold at a bargain price, enabling the purchaser to enter the market with a lower cost structure that would cause even more trouble for the incumbent.
2. For a good introduction to this debate, see Phillip Areeda and Donald Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act", 88 *Harvard Law Review* 697 (1975); F.M. Scherer, "Predatory Pricing and the Sherman Act: A Comment", 89 *Harvard Law Review* 869 (1976); and Douglas Greer, "A Critique

- of Areeda and Turner's Standard for Predatory Practices," 24 Antitrust Bulletin 223 (Summer 1979).
3. Frank Easterbrook, "Predatory Strategies and Counterstrategies," 48 University of Chicago Law Review 263 (1981) ("There is no sufficient reason for antitrust law or the courts to take predation seriously").
 4. See William Baumol, "Predation and the Logic of the Average Variable Cost Test," 39 Journal of Law and Economics 49, 52-53 (1996).
 5. Phillip Areeda and Donald Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act," 88 Harvard Law Review 697 (1975).
 6. The reason for this divergence is that MC is an incremental measure, whereas AVC is an average. As output increases, diminishing marginal returns to the factors of production raise the cost of producing each additional unit of output. MC eventually crosses the minimum of the AVC curve and thereafter begins to pull AVC upward. AVC, however, cannot catch up to the more rapidly rising MC in the short run.
 7. For a review of criticisms of the Areeda-Turner test, see James Hurwitz and William Kovacic, "Judicial Analysis of Predation: The Emerging Trends", 35 Vanderbilt Law Review 63-157 (1982); Joseph Brodley and George Hay, "Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards", 66 Cornell Law Review 738 (1981).
 8. See Section 2.2.4 below.
 9. Paul Joskow and Alvin Klevorick, "A Framework for Analyzing Predatory Pricing Policy", 89 Yale Law Journal 213 (1979).
 10. William Baumol, "Predation and the Logic of the Average Variable Cost Test," 39 Journal of Law and Economics 49 (1996) at 59; see also Phedon Nicolaides and Roel Polmans, "Competition in EC Telecommunications: Cross-Subsidisation, Access and Predatory Pricing", 22 World Competition Law and Economics Review 21, 33 (1999).
 11. Phillip Areeda and Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (2d ed. 2002), Vol. 3, para. 735 ("The problem with all such strategies is not that we doubt their existence or even their anticompetitive consequences. Rather, identifying them in the particular case without chilling aggressive, competitive pricing is far beyond the capacity of any antitrust tribunal").
 12. William Baumol, "Predation and the Logic of the Average Variable Cost Test", 39 Journal of Law and Economics 49 (1996); the AAC test was approved by the Canadian Competition Tribunal in *Commissioner of Competition v. Air Canada* (2003), 26 C.P.R. (4th) 476, [2003] C.C.T.D. No. 9 (Competition Tribunal), in accordance with airline-specific legislation; the AAC test was also given very careful consideration by an appellate court in *United States v. AMR Corp.*, 335 F.3d 1109 (10th Cir. 2003). The AAC test appeared in the literature on predatory pricing at least as early as 1981, in Janusz Ordover and Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation", 91 Yale Law Journal 8, 17-18 (1981).
 13. Firms engaging in predatory pricing strategies need to increase output for two main reasons. First, their lower pricing will stimulate overall market demand. Second, the predator must absorb the extra demand that was previously being supplied by its prey. See Section 2.2.2e) below.

14. Derek Ridyard, "Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic Analysis", 23 *European Competition Law Review* 286, 295 (2002).
15. William Baumol, "Predation and the Logic of the Average Variable Cost Test", 39 *Journal of Law and Economics* 49 (1996) at 62.
16. Aaron Edlin, "Stopping Above-Cost Predatory Pricing", 111 *Yale Law Journal* 941 (2002).
17. Einer Elhauge, "Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory", 112 *Yale Law Journal* 681 (2003).
18. See Geoff Edwards, "The Perennial Problem of Predatory Pricing", 30 *Australian Business Law Review* 170 (2002), 188 and note 92.
19. See *id.* at 188 note 93.
20. *MCI Communications v. AT&T*, 708 F.2d 1081, 1114 (7th Cir. 1983) (emphasis in original); see also Phillip Areeda and Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (2d ed. 2002), vol. 3, para. 736c2 ("As a practical matter, the price that actually maximizes a defendant's profits in the circumstances will seldom be knowable.").
21. But see *Compagnie Maritime Belge*, C-395/96 P, para. 97 (stating that "the mere fact that the aim of price competition was to drive a competitor from the market cannot render legitimate competition unlawful" but holding that it was unlawful for a defendant to reduce price to a level above its own costs but below those of a targeted entrant).
22. Paul Joskow and Alvin Klevorick, "A Framework for Analyzing Predatory Pricing Policy", 89 *Yale Law Journal* 213 (1979).
23. The recoupment test is not without its critics, either, and some of them argue that forecasting whether a predator is likely to be able to recoup its losses is at least as difficult as selecting and measuring the most appropriate costs for use in a price-cost test. See M.L. Denger and J.A. Herfert, "Predatory Pricing Claims After Brooke Group," 62 *Antitrust Law Journal* 541 (1994). However, even the critics do not suggest abandoning the recoupment test; they simply advocate conducting a price-cost test first.
24. An exception must be noted, however. Some nations also rely on "resale-below-cost" laws (which do not necessarily have market power thresholds) to punish what is considered to be predatory pricing. See Section 2.4.
25. In some countries, such as the US, it is sufficient that there be a wilful acquisition of market power as a result of anti-competitive conduct, or that there be an attempt to acquire market power with a dangerous probability of success. This is a desirable trait in a competition statute intended to cover predatory conduct because predators are not necessarily dominant when they begin their predatory campaign, but they will acquire a dominant position along the way if the strategy is successful. There is an anomaly in this respect in some other jurisdictions' laws, which require that the defendant already be dominant at the time of the predatory conduct. Some commentators have noted the importance of this difference. See Speech delivered by Philip Lowe, Thirtieth Annual Conference on International Antitrust Law and Policy, Fordham Corporate Law Institute, 23 October 2003, pp. 2-3 (commenting on Article 82); Geoff Edwards, "The Perennial Problem of Predatory Pricing", 30 *Australian Business Law Review* 170

- (2002), 196, 197, 199 (arguing that, for this reason, s. 46 of Australia's Trade Practices Act 1974 is "ill-suited to address predatory pricing conduct").
26. This effect is caused by the price elasticity of demand. See Section 2.2.2d).
 27. There is no clearly established consensus on the definition of entry barriers. Some regard them as costs necessarily incurred by new entrants that incumbents did not have to bear when they entered. Others view entry barriers as anything that permits incumbents to charge above-normal prices without attracting entry.
 28. This term refers to the percentage change in quantity demanded caused by a 1% change in price. Highly elastic demand, for instance, would mean that a 1% drop in price would cause, say, a 10% increase in the quantity demanded. Inelastic demand, on the other hand, would mean that the same drop in price would cause, say, only a 0.5% increase in the quantity demanded.
 29. This remains true even if the acquirer makes a failing firm defence. The agency will naturally examine why the target firm is failing, and if it is failing because of the acquirer's predatory strategy, then the acquirer will still face the agency's scrutiny – with respect to both the acquisition and the predatory pricing.
 30. D.M. Kreps and R. Wilson, "Reputation and Imperfect Information," 27 *Journal of Economic Theory* 253 (1982); P. Milgrom and J. Roberts, "Predation, Reputation and Entry Deterrence", 27 *Journal of Economic Theory* 280 (1982); Patrick Bolton, Joseph F. Brodley and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy", 88 *Georgetown Law Journal* 2239 (2000).
 31. Bolton, et al. (2000).
 32. The concept of reputational effects was at least treated respectfully, in dictum, in one US case. See *Advo, Inc. v. Philadelphia Newspapers, Inc.*, 51 F.3d 1191, 1196 (3d Cir. 1995) (finding that reputational effects are applicable in "a limited number of special situations" and that the plaintiff had not alleged any such special circumstances).
 33. *A. A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396, 1401-02 (7th Cir. 1989) (Easterbrook, J.); see also Richard Posner, *Antitrust Law: An Economic Perspective* 190 (1976) ("Especially misleading here is the inveterate tendency of sales executives to brag to their superiors about their competitive prowess, often using metaphors of coercion that are compelling evidence of predatory intent to the naïve").
 34. Furthermore, if a defendant makes a showing that its seemingly predatory behaviour should be excused because of a legitimate business justification, then predatory intent evidence should be allowed to give plaintiffs an opportunity to refute that showing. See Section 2.2.4.
 35. See *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 232 (1st Cir. 1983) (Breyer, J.) (noting that under an intent-based predation test, firms might refrain from describing the motives and consequences of their actions, thereby thwarting the test).
 36. William Baumol, "Predation and the Logic of the Average Variable Cost Test", 39 *Journal of Law and Economics* 49 (1996) at 54.
 37. A recent example of a product introduction LBJ (technically, a service introduction in this case) was described in a 29 April 2004 press release from the UK Office of Fair Trading. A bus company began service in a new geographic area and was accused of predatory pricing. Although the company's prices "were low enough in comparison to its costs to raise questions about predation," the OFT

found that the company had not infringed the Competition Act because compelling evidence showed that the company was merely attempting to establish a “more secure commercial basis” in the new area and that it neither intended to, nor believed it could, drive a competitor out of business. Thus the OFT concluded that the conduct in question was legitimate competition, and that consumers had benefited from a period of low prices without any weakening of competition. See “First Edinburgh Buses Not Predatory”, www.oft.gov.uk/News/Press+releases/2004/75-04.htm.

38. A network effects market is one in which the value of a good or service to a potential customer depends on the number of customers who already use that good or service. One consequence of a network effect is that the purchase of a good by one person benefits others who own the good – a common example is purchasing a telephone. By doing so, a person makes other telephones more useful.
39. Kenneth Elzinga and David Mills, “Predatory Pricing and Strategic Theory”, 89 *Georgetown Law Journal* 2475, 2485 (2001).
40. For an overview and explanation of the theory and literature, see Adriaan ten Kate and Gunnar Niels, “Below Cost Pricing in the Presence of Network Externalities,” in Einar Hope, ed., *The Pros and Cons of Low Prices*, Konkurrensverket/Swedish Competition Authority (2003), available at www.kkv.se/bestall/pdf/rap_pros_and_cons_low_prices.pdf, 97-129; see also Joseph Farrell and Michael Katz, “Competition or Predation? Schumpeterian Rivalry in Network Markets”, University of California, Berkeley, Economics Dept. Working Paper No. E01-306 (2001), available at <http://repositories.cdlib.org/iber/econ/E01-306/>.
41. *United States v. Microsoft*, 253 F.3d 34 (D.C. Cir. 2001). Interestingly, Microsoft’s recoupment came from preserving its monopoly in a different product market, not from ultimately raising its price in the browser market. Microsoft knew that if it allowed Netscape to remain a popular browser, Netscape would have been a threat to Microsoft’s operating system monopoly.
42. Adriaan ten Kate and Gunnar Niels, “Below Cost Pricing in the Presence of Network Externalities,” in Einar Hope, ed., *The Pros and Cons of Low Prices*, Konkurrensverket/Swedish Competition Authority (2003), available at www.kkv.se/bestall/pdf/rap_pros_and_cons_low_prices.pdf, 97, 99-100, 111-116.
43. *Id.* at 111-112.
44. *Id.* at 111-119; see also Derek Ridyard, “Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic Analysis,” 23 *European Competition Law Review* 286, 299 note 47 (2002).
45. Geoff Edwards, “The Perennial Problem of Predatory Pricing,” 30 *Australian Business Law Review* 170 (2002), 184. For a more thorough review of the complexities of distinguishing predatory pricing from systems pricing and loss leading in multi-product firms, see Andrew Eckert and Douglas S. West, “Testing for Predation by a Multiproduct Retailer”, in Einar Hope, ed., *The Pros and Cons of Low Prices*, Konkurrensverket/Swedish Competition Authority (2003), pp. 39-69, available at www.kkv.se/bestall/pdf/rap_pros_and_cons_low_prices.pdf, 50-55.
46. 15 USC. § 13(b).
47. *ILC Peripherals v. IBM*, 458 F. Supp. 423, 433 (N.D. Cal. 1978), *affirmed*, *Memorex v. IBM*, 636 F.2d 1188 (9th Cir. 1980); see also *Richter Concrete v. Hilltop Concrete*, 691 F.2d 818, 826 (6th Cir. 1982) (“it is not anticompetitive for a company to reduce its prices to meet lower prices already being charged by competitors”).

48. *United States v. AMR Corp.*, 335 F.3d 1109, 1121 n.15 (10th Cir. 2003).
49. *Compagnie Maritime Belge Transports v. Commission*, Opinion of Advocate General, para. 342, C-395-96O and C-396/96P [1998].
50. *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading*, Case No. 1001/1/1/01, paras. 342-343 [15 January 2002].
51. 83 C.P.R. (3d) 51, [1998] O.J. No. 4007 (Q.L.).
52. See the discussion of the *Germania* decision in Section 3.3.
53. *AKZO Chemie BV v Commission*, Case No. C-62/86 [1991] ECR I-3359; [1993] 5 C.M.L.R. 215, ECJ.
54. *Tetra Pak International v Commission (Tetra Pak II)*, C-333/948 [1996] ECR I-5951, para. 41 (“prices below average variable costs must always be considered abusive”).
55. Opinion of Advocate General Fennelly, *Compagnie Maritime Belge Transports v Commission*, C-395-96O and C-396/96P [1998], para. 127; see also *Aberdeen Journals v Office of Fair Trading*, [2003] CAT 11, para. 357 (“despite the apparently peremptory wording of... AKZO... and *Tetra Pak II*..., we do not exclude the possibility that, exceptionally, a dominant firm may be able to rebut the presumption of abuse”).
56. European Commission, “Commission’s Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector,” [1998] O.J. 98/C 265/02, paras. 110-116, available at <http://europa.eu.int/ISPO/infosoc/telecompolicy/en/ojc265-98en.html>.
57. That measure was used in *Deutsche Post AG*, in which the Commission found that Deutsche Post had infringed Article 82 by pricing parcel services below cost. 2001/354/EC, 5 May 2001, O.J. L125/27. Because *Deutsche Post* is a fidelity rebates case and that topic was covered in a previous roundtable, it is not discussed here. See OECD, “Roundtable on Loyalty and Fidelity Discounts and Rebates”, DAFPE/COMP(2002)21.
58. *Tetra Pak II*, C-333/94 P [1996] ECR I-5951, para. 44.
59. *Compagnie Maritime Belge Transports v. Commission*, Opinion of Advocate General, paras. 111-139, C-395-96O and C-396/96P [1998].
60. Einer Elhauge, “Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory”, 112 Yale Law Journal 681 (2003).
61. Speech delivered by Philip Lowe, Thirtieth Annual Conference on International Antitrust Law and Policy, Fordham Corporate Law Institute, 23 October 2003, pp. 6-7.
62. *Id.* at 6; *Wanadoo*, COMP/38.233 (16 July 2003), appealed to the European Court of First Instance, T-340/03 (pending).
63. Judgment of 1 February 2000, case 2000:2, *Statens Järnvägar v Konkurrentverket and BK Tåg AB*. See also T. Petterson and S.P. Lindeborg, “Comments on a Swedish Case on Predatory Pricing – Particularly on Recoupment”, 3 E.C.L.R. 75 (2001).
64. Decision 04-D-17, 11 May 2004, paras. 68, 71.
65. See, e.g., E.P. Mastromanolis, “Predatory Pricing Strategies in the European Union: A Case for Legal Reform,” 4 European Competition Law Review 211 (1998); Valentine Korah, *An Introductory Guide to EC Competition Law and Practice* (2000).

66. Case No. CA98/14/2002, *Predation by Aberdeen Journals Limited* (16 September 2002) (Decision of the Director General of Fair Trading) (hereafter, “*Aberdeen Journals*”), affirmed by Competition Appeal Tribunal (23 June 2003) (see OFT press release, 23 June 2003, “OFT Competition Ruling Upheld,” available at www.oft.gov.uk/news/press+releases/2003/pn+84-03.htm).
67. *Aberdeen Journals*, paras. 145-149.
68. *Aberdeen Journals*, Table in para. 181 (entry entitled “Review of *Aberdeen Independent* by Mr. Ezzat”).
69. Speech by John Vickers, Chairman of the Office of Fair Trading, “Abuse of Market Power”, 31st Conference of the European Association for Research in Industrial Economics, Berlin (3 September 2004), p. 10, available at www.oft.gov.uk/NR/rdonlyres/948B9FAF-B83C-49F5-B0FA-B25214DE6199/0/spe0304.pdf.
70. *Id.* at 23.
71. Privy Council Appeal No. 6 of 2004, 14 July 2004, [2004] UKPC 37.
72. *Carter Holt Harvey*, paras. 11-20, 42-43.
73. At the time the events in *Carter Holt Harvey* took place, Section 36(1) provided that “No person who has a dominant position in a market shall use that position for the purpose of a) Restricting the entry of any person into that or any other market; or b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or c) Eliminating any person from that or any other market.” Section 36 has since been amended, for the purpose of harmonisation with Australian law, to prohibit taking advantage of market power.
74. *Carter Holt Harvey*, paras. 53, 60.
75. *Id.*, para. 21.
76. *Id.*, para. 68. This is an interesting conclusion. Ordinarily, one would expect that when a firm can be characterised as “vulnerable”, when lower-cost entry has already occurred, and when the court has found that even if the new entrant were eliminated, another entrant probably would have appeared within a short time to take its place, then the firm would not be considered dominant.
77. *Id.*
78. *Id.*, paras. 16-20.
79. See note 25 above.
80. *Boral*, Judgment of Justice McHugh.
81. *Id.* (“S46 is ill drawn to deal with claims of predatory pricing under these conditions.”)
82. 509 US 209, 222, 224 (1993).
83. 509 US at 223.
84. *Id.*
85. *Id.*
86. *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 US 574, 589 (1986).
87. *Brooke Group*, 509 US at 224 (emphasis in original).
88. See *D&S Redi-Mix v. Sierra Redi-Mix and Contracting Co.*, 692 F.2d 1245 (9th Cir. 1982).

89. See *United States v. AMR Corp.*, 335 F.3d 1109, 1114 (10th Cir. 2003) (citing Patrick Bolton, Joseph F. Brodley and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy", 88 *Georgetown Law Journal* 2239 (2000)).
90. Derek Ridyard, "Exclusionary Pricing and Price Discrimination Abuses under Article 82 – An Economic Analysis," 23 *European Competition Law Review* 286, 295 (2002).
91. See G. Niels and A. ten Kate, "Predatory Pricing Standards: Is There a Growing International Consensus?" 45 *Antitrust Bulletin* 787 (2000).
92. Act Against Restraints of Competition, Section 20(IV)(2).
93. Art. L. 442-2 – 442-4.
94. Irish Competition Authority, "Response to the Competition and Merger Review Group Report on the 1987 Groceries Order", Discussion Paper No. 10 (2000), available at www.tca.ie/discpap.html. The same position is taken in Patrick Walsh and Ciara Whelan, "A Rationale for Repealing the 1987 Groceries Order", 30 *Economic and Social Review* 71 (1999).
95. One of the matters, *Australian Competition and Consumer Commission v. Qantas*, involved allegations that Qantas had misused its market power on a certain route after Virgin Blue Airlines had entered. This case is not discussed here because the ACCC ended its enforcement action after determining that, during the time since the action began, the airlines market had changed and competition had been enhanced. See ACCC Press Release, "Qantas Airlines Matter Discontinued", 21 November 2003, available at www.accc.gov.au/content/index.phpml/itemId/402657/fromItemId/378016.
96. 335 F.3d 1109 (10th Cir. 2003).
97. *United States v. AMR Corp.*, 140 F. Supp. 2d 1141, 1152-53 (D. Kan. 2001).
98. *AMR*, 335 F.3d at 1112.
99. See Brief for Appellant United States of America, 11 January 2002, available at www.usdoj.gov/atr/cases/f9800/9814.htm.
100. *AMR Corp.*, 140 F. Supp. 2d at 1199, 1202.
101. *AMR Corp.*, 335 F.3d at 1115. For an economist's view of why the same analysis ought to apply to both predatory pricing and predatory capacity expansion, see Aaron Edlin and Joseph Farrell, "The American Airlines Case: A Chance to Clarify Predation Policy", in John Kwoka and Lawrence White, eds., *The Antitrust Revolution* (2002), available at http://works.bepress.com/aaron_edlin/26/, 21-22.
102. See Greg Werden, "The American Airlines Decision: Not with a Bang but a Whimper" (September 2003), US Department of Justice Antitrust Division Working Paper No. EAG 03-8, available at <http://ssrn.com/abstract=446262>, 8.
103. *AMR Corp.*, 335 F.3d at 1119-20.
104. *AMR Corp.*, 335 F.3d at 1021 n.15.
105. Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service (the "Airline Regulations"), paras. 1(a) and (b); see *Commissioner of Competition v. Air Canada* (2003), 26 C.P.R. (4th) 476, [2003] C.C.T.D. No. 9 (Competition Tribunal), para. 21.
106. Section 79 concerns abuse of a dominant position.

107. Because some aspects of this case are still pending, the discussion here will be limited to a neutral summary of the Tribunal's decision.
108. *Air Canada*, paras. 155-165.
109. *Air Canada*, para. 76.
110. Note that this is not a question of profit maximisation. It is simply a question of whether, by cancelling a flight, the defendant could have shifted the resources made idle by that cancellation to an activity that earned any positive amount of profit (without necessarily earning the maximum profit possible).
111. This approach is supported by Aaron. Edlin and Joseph Farrell, "The American Airlines Case: A Chance to Clarify Predation Policy", in John Kwoka and Lawrence White, eds., *The Antitrust Revolution* (2002), available at http://works.bepress.com/aaron_edlin/26/, p. 9 No. 10, and by William Morrison, "Dimensions of Predatory Pricing in Air Travel Markets," 10 *Journal of Air Transport Management* 87, 91 (2004).
112. *Air Canada*, para. 35.
113. *Air Canada*, para. 337.
114. Beyond contributions were taken into account by both parties in AMR.
115. *Air Canada's* failure of the AAC test, however, has not yet resulted in a finding that *Air Canada* had abused a dominant position. Other elements, including dominance and a practice of anti-competitive acts, would have to be established at the Phase Two hearing.
116. Federal Cartel Office, decision of 18 February 2002, case B-9-144/01; FCO Press Release, "Higher Regional Court Düsseldorf Provisionally Confirms the Prohibition of Lufthansa's Abusive Pricing Strategy", 10 April 2002, available at www.bundeskartellamt.de/wEnglisch/News/Archiv/ArchivNews2002/2002_04_10.shtml.
117. After the FCO issued its decision, several other LCCs entered the market for a number of domestic routes in Germany, causing fares to decline. That led Lufthansa to implement a new fare system for all of its domestic flights, not just for those routes in which it is not dominant. This development suggests that Lufthansa's fare reduction on the Germania route in question may have been due to legitimate competition, not a predatory strategy. The FCO appears to have reached the same conclusion, because in September 2003 it set its decision aside and settled the matter with Lufthansa while part of it was still pending before the Düsseldorf Court of Appeals. See Ulrich Quack and Rüdiger Schütt, "Lufthansa/Germania: German Federal Cartel Office Takes Tough Approach", ABA Section of Antitrust Law Spring Meeting Course Materials, 31 March 2004, p. 962.
118. Morrison has argued that this approach is likely to be inaccurate, arbitrary and difficult to administer. William Morrison, "Dimensions of Predatory Pricing in Air Travel Markets", 10 *Journal of Air Transport Management* 87, 92 (2004) ("using a demand-based valuation of the [incumbent's] additional services requires that the competition authority is able to uncover the distribution of consumer preferences over the particular bundle of services offered . . . Serious errors in this calculation could occur[.]").
119. *Spirit Airlines, Inc. v. Northwest Airlines, Inc.*, No. 00-71535 (March 31, 2003, E.D. Mich.).
120. See, e.g., Steven Salop and David Scheffman, "Raising Rivals' Costs", 73 *American Economic Review* 267 (1983).

121. David Scheffman and Richard Higgins, "20 Years of Raising Rivals' Costs: History, Assessment, and Future", *George Mason Law Review* (forthcoming), available at www.ftc.gov/be/RRCGMU.pdf, at p. 7.
122. Competition Bureau, "Enforcement Guidelines on the Abuse of Dominance Provisions", Section 4, July 2001, available at <http://competition.ic.gc.ca/epic/internet/incb-bc.nsf/en/ct02215e.html>.
123. Frank Easterbrook, "When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?" 2003 *Columbia Business Law Review*, 345-358 (2003).
124. Patrick Bolton, Joseph F. Brodley and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy", 88 *Georgetown Law Journal* 2239 (2000).
125. See, e.g., Joseph Farrell and Garth Saloner, "Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation", 76 *American Economic Review* 940 (1986).
126. E.g., Plaintiff's Complaint in *United States v. IBM*, No. 69-200 (S.D.N.Y. filed 12 January 1969), paras. 20-21.
127. *Berkey Photo, Inc. v. Eastman Kodak Corp.*, 603 F.2d 263 (2d Cir. 1979); *ILC Peripherals Leasing Corp. v. IBM*, 458 F. Supp. 423, 436 (N.D. Cal. 1978).
128. Janusz Ordover and Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation," 91 *Yale Law Journal* 8, 53 (1981).

Predatory Foreclosure

3. Summary of the Discussion

Summary of the Discussion

The Chairman opened the roundtable by asking John Vickers of the UK delegation to discuss portions of his recent paper on abuse of dominance and to present his views on the appropriate tests for predation.

1. Presentation by John Vickers of the UK delegation

Mr. Vickers began by pointing out that over the last five to ten years, the law and policy toward anticompetitive agreements in Europe has shifted from form-based approaches to more economics-based approaches. The European Commission is now reviewing the area of abuse of dominance and again one of the fundamental questions is the extent to which the Commission's approach should be form-based or economics-based. There is wide agreement that the underlying principles or standards should be clearer, too. At the heart of this review are fundamental issues such as how to define competition on the merits, undistorted competition, and harm to competition. Although the underlying standards cannot be debated in the abstract, there is also a danger that merely discussing different candidate abuses without thinking about underlying principles would invite inconsistency and incoherence. Mr. Vickers therefore recommended that the competition policy community strive toward equilibrium between underlying principles and goals on the one hand and approaches to different types of abuses on the other. His paper examines, among other things, below cost pricing abuses and seeks to link them to the debates on underlying standards.

One of those standards is the sacrifice test, sometimes called the “but for” test, which holds that conduct by a dominant firm is unlawful if it makes no business sense but for its exclusionary effect. The essence of conduct that fails this test is some sacrifice of profit by the dominant firm in the short run in exchange for the longer run “gain” of lessened competition. The test seems to distinguish between deliberately exclusionary pricing on the one hand and responding to competition in a perfectly healthy way on the other. So it has at least some superficial appeal, Mr. Vickers said.

He added, however, that the test is unsatisfactory because it does not deliver a substantive standard. Making “no business sense but for the exclusionary effects” is too vague and subjective. Furthermore, the test leaves

some difficult practical issues unresolved, such as what the alternative behaviour (as opposed to the sacrifice) might be. In addition, although it has been proposed that sacrifice should be a necessary condition for a finding of illegality, some conduct may entail no short run profit sacrifice yet still be exclusionary. “Cheap exclusion” falls into this category. Therefore, profit sacrifice might be a useful principle for looking at some aspects of abuse, but it is not promising in terms of providing a general foundation for what constitutes exclusionary behaviour.

The second broad test is the “as efficient competitor” test, which asks whether a dominant firm’s conduct would be likely to exclude rivals that are as efficient as the dominant firm itself. Some of the cost benchmarks used in the case law on predatory pricing are related to the as efficient competitor test. This test has some merit, too. It guards against the danger of protecting competitors rather than competition because under competitive conditions the market should be served by the most efficient firms. Some argue that the test is too lax because consumers can be harmed in many ways, not only by the exclusion of competitors as efficient as the dominant firm. And there are difficult questions about the scale of operation at which one should assess firms’ costs. If new entrants are small and have not yet worked their way down the marginal cost curve, then they may be less efficient than a dominant firm in the short run, but if they were able to survive longer they might eventually be equally or more efficient rivals.

The third general standard holds that conduct is not unlawful unless there is a tendency for it to cause consumer harm. In terms of predatory pricing, this is the issue of recoupment. But should it be necessary to make a showing of consumer harm to find abuse, and if so, what standard should apply: actual harm, a dangerous probability of harm, or a mere capability of causing harm? Should agencies sometimes take cases even when there is no prospect of consumer harm? If so, what would be the grounds for doing so?

Mr. Vickers cautioned that it is best to be cautious when intervening against alleged predatory pricing conduct. Given that the conduct involves low prices for consumers, government intervention could be counterproductive for consumers, efficiency and the general economy. Finally, he noted that the case law on recoupment in Europe seems to be starkly different from that in the US because there appears to be no need to show it in European cases. In any case, Mr. Vickers said, it is good practice for agencies to think very hard about the recoupment issue both as a cross check on whether a dominant position really exists and to be sure that by taking action, the agency would really be protecting consumers.

2. Protecting competitors or protecting competition?

The Chairman steered the discussion from theory to practice, beginning with Japan. He noted that Japan can fight predatory practices under either Section 3 of the Anti Monopoly Act, which prohibits practices “restricting competition substantially in any particular field of trade”, or Section 19, which prohibits unfair trade practices. To apply Article 19, three requirements must be met: charging prices lower than the cost of supply, continuing such pricing, and tending to cause difficulties to the business activities of other entrepreneurs. The Chairman asked whether this approach is consistent with the EU approach, which views predatory pricing as a concern not because it harms competitors, but because it harms competition.

A delegate from Japan said that The Antimonopoly Act aims to promote free and fair trade. Therefore, the JFTC’s approach to predatory pricing is to protect competition. In light of the third criterion under Section 19, it might seem that law enforcement against predatory pricing in Japan protects competitors rather than competition itself. However, the three criteria are considered in their totality. In other words, the third condition – whether the competitors are facing difficulties in continuing business – is meant to test whether market competition was injured by something other than the predator’s efficiency.

The JFTC can also restrict predatory pricing as a private monopoly violation of Article 3. Under that article, the JFTC needs to prove that conduct substantially impedes the functioning of the relevant market as a whole. In contrast, in the case of unfair trade practices, this condition would not be considered. The delegate said that it has been difficult to pursue most of the predatory pricing cases as private monopolization so far.

The Chairman next addressed Switzerland’s contribution, which notes that it is not easy to distinguish between predatory behaviour and fierce but healthy competition. According to Article 7(1) of the Act Against Cartels, practices of dominant enterprises are unlawful when such enterprises, through the abuse of their position, prevent other businesses from entering or competing. More precisely, Article 7(2)(d) states that “the undercutting of prices or other conditions directed against a specific competitor” may constitute an unlawful practice. The Swiss contribution presents several cases, including one involving the allegedly predatory launch of a newspaper. The contribution states that “even if the investigation revealed that the incumbent newspaper was driven out of the market, the new newspaper would not be able to increase its price above the competitive level in the long run due to remaining competitive forces”. The Chairman asked how that statement fits with the wording of Article 7(2), which seems to indicate that undercutting a specific competitor can be unlawful?

A delegate from Switzerland explained that there are two provisions in Swiss law that address predatory pricing. One is in the Cartel Act and concerns dominant positions, while the other one is in the Act on Unfair Competition. The latter provision is controversial and essentially makes it unlawful to offer low prices in order to deceive customers, such as when a firm lures people onto its premises with very low prices for one segment but it charges normal or high prices in other segments. In the Swiss Competition authorities' practice, the Cartel Act provision is more important.

The delegate said that the case involved newspapers that normally operate in distinct regions. There are also sub-regions, in which a newspaper may issue separate editions. In this case, an incumbent newspaper in one sub-region argued that a regional newspaper should not be allowed to launch a sub-regional edition and experience losses in doing so. The competition authorities used the recoupment test in the fashion recommended by Mr. Vickers, i.e., as a cross check for dominance. They found that in the regional markets, there was adequate competition and even if the outcome of the launch in question turned out to be that the complaining competitor was driven out, that would not mean that the alleged predator is dominant. In fact, it would have no ability to raise prices above the competitive level. So the agency reasoned that since there was no possibility of recoupment, then there was no dominance in the first place.

3. Which measure of cost is appropriate to assess predatory pricing?

The Chairman turned to the cost measures used in analysing predatory pricing, noting that there are widely different practices among jurisdictions in this area. He remarked that the Norwegian contribution presents data concerning the airline industry in Norway and discusses two possible cost benchmarks: the avoidable cost test and an incremental cost and revenue test. He invited the Norwegian delegation to discuss these two approaches.

A delegate from Norway described the Norwegian aviation markets. There was a period of monopoly by SAS beginning in October 2001. The Norwegian Competition Authority's prohibition of SAS's frequent flier program on domestic routes led to immediate entry on the four major routes by the airline "Norwegian". Since then, Norwegian has expanded into a total of 12 domestic routes. The NCA is currently concerned that SAS may be following a predation strategy and is reviewing evidence.

Norwegian is the more efficient company. When it entered, it quickly gained a share of about 20 per cent on major routes. SAS maintained its capacity at the pre-entry level but eventually cut prices substantially. This raised the question of whether they were engaged in a price or capacity

predation strategy. The NCA does not have a clear incremental range of output in mind, unlike the American Airlines case. The question is whether the NCA can nevertheless apply the incremental cost and revenue test discussed in that case. Professor Lars Sørsgard, now the NCA's Chief Economist, has pointed out that applying a price cost test over an entire route risks being too lenient.

Applying the avoidable cost test at the route level, one averages out costs and revenues on all the flights on that route. Whether particular flights are losing money is not analysed by the test. One point of view is that this is an appropriate test as long as one is dealing with pure price predation. However, if one is dealing with capacity predation, one could argue that applying the avoidable cost test on a route level is too easy for defendants. If there is a clearly relevant increment in capacity, one can look at incremental costs and revenues related only to that range of capacity.

One could say that average incremental revenue (AIR) is the average price paid by passengers on the specific flights in the isolated range of output. However, due to two effects, this overestimates AIR. First, there is a cannibalization effect. Some of the passengers on the excess flights would have taken other flights on the route, so they are not genuinely new passengers and thus should not be included when calculating AIR. Second, there is a price effect. To fill up the excess flights, prices on the route have to be lowered. The income loss on the non-excessive flights should therefore be subtracted to produce a good estimate.

This leads to the following questions and conclusion. Can maintaining capacity at the pre-entry level be regarded as capacity predation? If so, would it be meaningful to apply an incremental cost/revenue test related to the excess capacity only? When analysing capacity predation, a price/cost test based on the whole route may be too lenient.

The Chairmen then addressed Mexico's legal framework for analysing predatory pricing. Article 7 Index 1 of the Rulings of the Federal Law of Economic Competition (FLEC) establishes that systematic sales of goods or services at prices below their average total cost (ATC) or occasional sales below the average variable cost (AVC) are the proper benchmarks. Mexico's contribution states that the Rulings takes into account the possibility that AVC can underestimate marginal cost and that any price below ATC should undergo a rule of reason analysis according to the law. The contribution also presents a case concerning Warner Lambert in the informal market for chewing gum.

A delegate from Mexico explained that the regulations of the FLEC characterise predation as a relative monopolistic practice that is subject to rule of reason analysis. There must be a finding that the predator has substantial market power in the relevant market prior to evaluation of the actual practice. In addition, the competition authority must weigh efficiency considerations

when making its final determination. These requirements have allowed the FCC to dismiss cases involving conduct that may harm competitors but is not harmful to the competitive process itself.

The delegate further explained that, at present, the FCC is not actively prosecuting predatory practices because the legal provisions relating to those practices have a weak legal basis. The FCC was investigating predation based on Article 10 Index 7 of the FLEC, which defines all the actions that unduly damage competition as relative monopolistic practices in general. However, the Supreme Court determined in several cases that the provision is unconstitutional because it fails to establish the specifics necessary to determine the type of violation that merits the sanction in the legislation. It is therefore necessary to amend the FLEC.

The *Warner Lambert* case, which the FCC began investigating in 1996, concerned whether Warner Lambert launched its Clark's product in a manner designed to improperly displace Canel's, a competitor. The relevant market was chewing gum in the national territory. Warner Lambert was marketing Clark's through street vendors and Chiclets-4 in small stores. The FCC found that selling a product below cost acted as a barrier to entry, so that any entrant would require a large investment to survive predation. The FCC confirmed that Warner Lambert had substantial power in the chewing gum market where its share in net sales was above 50 per cent and between five and seven times the share of its competitors. Warner Lambert also had the ability to differentiate prices between brand names and market segments, noting as an example the significant price disparity between Warner Lambert's Chiclets-4 and Clarks products.

The FCC also found that Warner Lambert had incurred losses throughout most of the investigation period because its price was persistently below its ATC. Furthermore, Canel's market share losses between 1993 and 1994 were very similar in size to Warner Lambert's share increases in a market that was relatively stable in size. This indicated that some Canel's customers had switched to Warner Lambert's product as a result of Clarks' artificially low price. As a result, the Commission imposed a fine on Warner Lambert and enjoined it from pricing its Clarks product in a predatory fashion.

The Chairman noted that the German contribution states that in the *Lufthansa/Germania* case, both the Bundeskartellamt and the Higher Regional Court rejected marginal cost and AVC as cost measures for the airline industry and used ATC instead. He asked the German delegation to explain what the case was about and why ATC was the relevant cost.

A delegate from Germany began by noting that Lufthansa was the only carrier operating scheduled flights between Frankfurt and Berlin until November 2001. A roundtrip ticket cost about 485 €, but by 1 January 2002

Lufthansa was charging only 105 € for a one-way ticket. The reason for this dramatic price cut, which occurred only on the Frankfurt-Berlin route, was that the low cost carrier Germania entered this market with a one-way fare of 99 €. According to the investigation, Lufthansa's offer was below its ATC as calculated in Lufthansa's own profitability evaluation. Net of passenger fees and value-added tax, the Lufthansa offer was equivalent to a price of roughly 62 €. Lufthansa's ATC was about 95 € per passenger.

Furthermore, Lufthansa's offer included several features that were not included in Germania's, such as higher flight frequency and better service. The Bundeskartellamt concluded that these extras had an equivalent value of at least 35 € per passenger and therefore that Lufthansa had undercut Germania's offer. To resolve the case, the Bundeskartellamt prohibited Lufthansa from charging a price less than 35 € above Germania's price for two years. The Higher Regional Court affirmed, but lowered the price differential from 35 € to 30.50 €.

The German delegate stated that the appropriate cost measurement in predatory pricing cases differs from industry to industry. In network industries, for example, marginal costs will be close to zero because nearly all costs are fixed. In addition, it is difficult to differentiate which costs are variable and which are fixed. In the long term costs tend to be variable, but in the short term they may be fixed. Another problem is cost accounting in multi-product firms. Overhead expenses typically create great difficulties in allocation. In the airline industry, the marginal cost for one additional passenger is close to zero as long as the plane is not fully booked. If the plane is fully booked, however, an additional passenger might create extremely high marginal costs because an additional airplane is required. Another aspect is that flight prices are highly differentiated. The profitability calculation for a certain route will therefore always be a mixed calculation; differentiated prices need to cover the costs on average. Under these circumstances, the ATC is a much more meaningful cost measure than MC or AVC.

The delegate added that *Lufthansa* is somewhat similar to the *Wal-Mart* case. That was a resale-below-cost case handled by the Bundeskartellamt and confirmed in principle by the German Federal Supreme Court. The rationale behind the case was the same as in *Lufthansa*: to prevent the incumbent from squeezing competitors out of the market with the result of more concentration, which would ultimately have caused higher prices and lower quality. As in *Lufthansa*, it was appropriate to take a middle term prospective to evaluate the incumbent's pricing. Short term benefits like lower prices for consumers can quickly become long term disadvantages, which are more difficult to cure.

4. Are prices below AVC always predatory? Are prices below cost but above a competitor's cost predatory? Can a price above a firm's own cost be predatory?

The Chairman remarked that several contributions suggest that prices below AVC are not necessarily predatory. There is a greater diversity of views, however, on whether prices above cost, particularly ATC, can be considered predatory. The contribution from New Zealand states that price cutting is predatory if it has the purpose of harming competition, and that no New Zealand cases seriously discuss whether pricing must be below-cost to be deemed predatory. The Chairman invited the New Zealand delegation to discuss how it assesses predatory pricing.

A New Zealand delegate explained that the Commerce Act does not refer directly to predatory pricing. Section 27 prohibits arrangements that have the purpose or effect of substantially lessening competition, whereas Section 36 prohibits use of market power for the purpose of deterring a competitor. The approach to predatory pricing depends on which section is relevant to the particular case at issue.

Cases involving predatory pricing usually involve allegations that a party abused its market power. To establish the necessary causal link between substantial market power and conduct under New Zealand law, it is necessary to compare two scenarios: the actual scenario, in which a party has substantial market power, and a hypothetical scenario, in which it does not have market power but is otherwise similarly positioned. The key question is whether the conduct would have occurred in the more competitive scenario.

In New Zealand, the delegate continued, the most important issue is to establish the link between the predatory pricing conduct and the use of substantial market power. Dominant firms must be allowed to compete. The problem with accepting the proposition that predatory pricing is established by some measure such as pricing below AVC is that it fails to establish, by itself, the use of market power, as it does not distinguish for example between a non-dominant party with financial strength and a dominant party with equal financial strength.

The Privy Council recently stated that the line between legitimate competition and anti-competitive conduct is not crossed simply by lowering prices. It is crossed when a firm with substantial market power takes advantage of its ability to raise prices without losing market share. Cutting prices becomes unlawful only when a firm with substantial market power is shown to have cut prices with a view to recoupment. It is the ability to recoup, not the ability to cut prices, that harms consumers. In New Zealand, therefore, pricing below cost is a relevant factor but is not of primary importance.

Finally, the New Zealand delegate noted that there has been considerable discussion and some criticism regarding *Carter Holt Harvey*. The contentious issue is whether a legitimate business justification can negate taking advantage of market power under Section 36. The CHH case had the effect of building a legitimate business defence into Section 36. There is already a debate about whether Section 36 is robust enough, so this has now become a policy issue for the government.

The Chairman then highlighted Korea's contribution, which explains that it is possible for prices above ATC to be deemed predatory in that jurisdiction. The Monopoly Regulation and Fair Trade Act stipulates that any activity that unduly excludes competitors can constitute an abuse of dominance prohibited under Article 3-2. The contribution states that the KFTC controls abuse of dominant positions when dominant businesses exclude competitors by selling below the "ordinary transaction price". That means that even setting a price above total costs could still be considered predatory. The Chairman asked the Korean delegation to elaborate on its law and enforcement policy.

A delegate from Korea said that the MRFTA distinguishes undue discount sales by general businesses from undue discount sales by dominant firms. Discount sales by general businesses are governed by Article 23 of the prohibition on Unfair Trade Practices, which requires prices that are much lower than their costs. Court cases recognize the relevant cost as total cost, which means the sum of total sales costs and non-operating expenses, such as interest on a loan. But undue discount sales by dominant businesses are governed by Article 3 of the MRFTA, which merely requires prices lower than ordinary prices. This condition is much stricter because dominant businesses have a higher probability of monopolising markets and harming competition. The KFTC, however, has not had any cases in which it applied the MRFTA to the above-cost prices.

The delegate noted that, for dominant firms, the MRFTA captures limit pricing strategies because limit prices are lower than ordinary prices. He stated his view that both predatory pricing and limit pricing should be controlled by the competition laws, or else those practices should both be abandoned by the laws. Even if limit pricing is prohibited, incumbents are still able to win customers through non-price competition.

The Chairman observed that, in contrast to the situation in Korea, Chinese Taipei has had a case in which an entrant complained that the incumbent was engaging in predation while keeping its price above its costs. He invited the delegation from Chinese Taipei to discuss the reasons why it rejected that complaint.

A delegate from Chinese Taipei said that the FTC considers pricing to be predatory when a monopolistic firm sets its price at a level much lower than

cost, so that it is sacrificing short term profit to drive competitors from the market or block their entry, thereby enabling it to gain excessive profits in the long-term. All four of the following conditions must be met:

- the firm is a monopoly or has market power in the relevant market (the market share of the enterprise must be above 50 per cent);
- its price is much lower than its cost (different measures of cost may be applied in different types of cases);
- the firm is capable of hindering or excluding competitors that operate with the same efficiency; and
- a significant entry barrier exists, which enables the firm to compensate for its initial losses by raising price above the competitive level after competitors are forced out of the market.

Answering the Chairman's question, the delegate stated that the FTC did not pursue the incumbent that set its price above its own costs, while still keeping its prices lower than the entrant's, in view of the requirement that the pricing strategy hinder or exclude equally efficient competitors, i.e., those with the same or lower cost. If the incumbent is not allowed to set its price slightly above its cost but still lower than its rival's, inefficient competitors may be attracted to the market. That would protect inefficient competitors rather than competition, a result that would promote neither consumers' interest nor allocative efficiency.

The Chairman turned to Turkey's contribution, which discusses a case involving a state owned enterprise that may have priced below its AVC but equal to or above the cost of its competitors. He asked whether, if that were the case, this pricing practice would be considered predatory.

A delegate from Turkey answered that the incumbent in that case, Turkish Maritime Enterprises (TDI), has much higher costs than its rivals because of the impact that a very effective trade union has on labour costs. TDI operates ferries on several lines. It has a monopolistic position on one line and therefore charges extremely high rates. On another line, however, TDI's prices are close to its rival's price but approximately 50 per cent lower than its own average cost. The Turkish Competition Authority recommended prosecuting TDI, and although this suggestion was refused by the Competition Board, the Council of State later rejected the Competition Board's decision. The most important issues in the case are, first, whether to accuse a firm that charges prices that are lower than its costs even if rivals are not forced to exit. The second issue is the legality of using economic power in one geographic or product market to obtain a dominant position in another market where competition exists.

5. Should the “meeting competition” defence be recognised? Should limit pricing be tolerated?

The Chairman noted that the contributions reveal varying opinions on the question of whether a meeting competition defence should be allowed. Denmark’s contribution, for example, states that “even dominant enterprises are allowed to meet competition by lowering prices. So far, prices below costs have not been considered predatory if the dominant enterprise did not undercut prices offered by other suppliers”. The Chairman asked the Danish delegation whether there could be a possibility of exclusion if a well established firm systematically matched the price of a new competitor trying to establish itself in the market.

A delegate from Denmark replied that the Danish Competition Authority has applied the meeting competition defence because it is required to follow European practice, and various European court rulings have upheld that defence. In some instances, dominant firms have been permitted to price below AVC to meet the price of competitors. Such prices must be defensive, however, meaning that they are targeted at the dominant firm’s existing customers. This defence should be applied cautiously because it could be abused. For example, it could give a dominant firm a reputation that it would always meet any entrant’s price, which could have a significant deterrent effect. On the other hand, one should not tie the hands of the dominant firm to an extent that impedes the competitive process.

The Chairman compared Denmark’s acceptance of the meeting competition defence with Chinese Taipei’s tolerance of limit pricing strategies. The latter’s contribution states that “limit-pricing strategies should be seen as ordinary pricing competition strategies used by an incumbent when faced with the threat posed by potential new entrants”. The Chairman asked the delegation from Chinese Taipei to describe how far it goes in allowing limit pricing strategies.

A delegate from Chinese Taipei said that in contestable markets, even if the incumbent uses limit-pricing to set its price at a level that makes potential competitors believe the post-entry market would be unprofitable (thus making them abandon any plan to enter that market), those strategies will be treated as ordinary competitive strategies that incumbents use when facing a challenge from new entrants, and will therefore not be deemed predatory. As long as potential competitors can enter or re-enter the market if the incumbent raises its price, thereby preventing the incumbent from recovering any losses it incurred and from earning excessive profits, the pricing strategy cannot be successful so it will not be considered predatory.

6. In which market should predation be observed?

The Chairman next addressed the subject of predation by a dominant firm in a market in which it is not dominant. He focused on the EU's contribution, which states that predatory pricing by a dominant firm in an unrelated market where it is not dominant and where the predation will have effects only in that unrelated market will not normally be an abuse under Article 82. An exception is the Commission's policy in sectors where activities are protected by legal monopolies and where the prevention of cross subsidisation is relevant. The Chairman asked the EU delegation to clarify why a dominant firm could not cross-subsidise its activities in a market in which it is not dominant precisely to acquire such a position in that market and why, if the firm could do that, the practice would not be considered predatory. He also requested an explanation of why the Commission makes an exception for firms protected by legal monopolies.

An EU delegate first reminded the Committee of the principle that dominance itself is not illegal. On the contrary, dominance is sometimes a natural result of competition on the basis of performance. He also mentioned that the Commission does not apply its unilateral conduct statute to protect competitors from competition. Both dominant firms and ordinary competitors are allowed to compete. In general, the Commission would be very hesitant to pursue a company that used its deep pockets to fund aggressive conduct in a totally unrelated market. However, there are a number of court rulings finding that if a company used its market power in market A to extend that power to market B, then that can be an abuse. The Commission applies those rulings where market B is closely related to market A because in that situation, the conduct usually has an impact on market A, as well (by strengthening the company's dominant position in that market). In *Tetrapak*, for example, which related to aseptic and non-aseptic packaging, the court found that the two markets were closely related. The abuse found in the non-aseptic market was also likely to strengthen Tetrapak's position in the aseptic market, where it was clearly dominant.

Another scenario mentioned by the EU delegate involves a state monopoly or an incumbent in a recently liberalized market who has control of an infrastructure and leverages its monopoly power into a new area. Again, the goal is to distinguish these cases from situations where a company acquires dominance from performance on the merits. A state-sanctioned monopoly has a guaranteed revenue stream that it can use to cross-subsidise its activities in neighbouring markets and thereby acquire dominance based not on the merits, but on the fact that it is a state monopoly in a different market.

7. Is there a need for a recoupment test to establish predation?

The Chairman then steered the discussion toward another test for predation – the recoupment test. He remarked that the US contribution states that “to prove a predatory pricing claim, the plaintiff must be able to show that the defendant firm has priced below a good estimate of marginal cost. In addition, a predatory pricing claim must pass the recoupment test. The need for a recoupment test may not be self-evident, yet it serves as a valuable safeguard against confusing aggressive pro-consumer competition with anticompetitive conduct”. The Chairman asked the US delegation to explain how this can be done and why it constitutes a safeguard against confusing pro-consumer competition with anti-competitive conduct.

The US delegate said understanding the commercial and legal history in markets may be more important than trying to find precisely the correct terms and formulations for various cost measures. Different conditions exist in different countries, so the cost measure that is appropriate to use in one jurisdiction may differ from what is appropriate to use in another jurisdiction. The US’s main point regarding recoupment is that it is a fundamental consideration for any agency that is seriously examining the consumer welfare effects of predatory pricing. A likelihood of recoupment means that the predator is probably going to be able to sustain a price increase and an output decrease.

The delegate noted that the elements of the American recoupment test are not all presently reflected in the dominance test used by the European Commission. Regardless of the nominal heading that the factors are considered under, however, the purpose of all of them is to establish a confident expectation that consumer welfare will decline via a sustainable price increase or output decrease.

Another US delegate added that in competitive industries there are many legitimate reasons why firms sometimes price below cost, such as promotional pricing and loss leaders that draw people into the stores. There is a more recent recognition that in network effects industries, subsidising membership actually leads to more competition between networks and thus enhances social welfare. Therefore, anti-competitive behaviour should not be presumed based solely on an observation of below cost pricing. To conclude that below cost pricing is anti-competitive, an agency should have evidence that such pricing is part of a long run strategy to incur initial losses via predation that will lead to a comparable increase in profits in the long run due to the exclusion of competition. If recoupment cannot be shown to be likely, then either there is some other explanation for the below cost pricing, costs are not being measured correctly, or the situation is being misunderstood. The delegate deferred the answer to the Chairman’s question about how to carry

out the recoupment test, noting that it is case-specific and that it would come up again during the discussion of *American Airlines*.

The Chairman noted that the EU's contribution seems to take a different view of recoupment. It states that "if the price charged by the dominant company is below AAC (Average Avoidable Cost) this means the dominant company incurred a loss that it could have avoided... [T]his is often considered sufficient to presume that the dominant company made this sacrifice in order to exclude the targeted competitor... The presumption that below AAC the pricing of a dominant company can be assessed as predatory implies that once the authority has established that the price charged was below AAC it does not need to further justify its decision[.] In such a case it would be up to the dominant company to show that it can objectively justify its pricing". The Chairman asked the EU delegation to expand on its statement in light of the US's points.

A delegate from the EU replied that in fact he likes the recoupment test because it is a way to prove that what looks good for consumers at first may, over time, be extremely bad in the long term. At the same time, the EU already has a threshold requirement to prove dominance, which necessarily involves a consideration of entry barriers. Ordinarily, where there is a truly dominant firm that prices below its AVC, then it is appropriate to reverse the burden of proof so that it is up to the company to provide a justification for its below-cost prices.

The Chairman asked the Danish delegation to explain its contribution's statement that "the possible existence of reputational effects makes the possibilities for recoupment difficult to prove and so far, recoupment has not been considered in Danish case law". He also asked whether the delegation thinks that recoupment tests are generally useless, and if so, to identify circumstances where that would be the case.

A delegate from Denmark first made a point about costs: whether a cost should be called fixed or variable depends on the relevant time horizon. If it is long enough, then everything is variable. The appropriate time horizon is the period during which the alleged conduct occurred. With respect to recoupment, even though the Danish Competition Authority has not applied a formal recoupment test, in reality it has given consideration to reputation, deterrence, barriers to entry, price elasticity of demand and other factors that are taken into account when considering recoupment. The bottom line is and should be a consumer surplus test. It might be a good idea to think about whether the recoupment test should be formalised in European legislation, since the test is already being considered in practice.

8. Must recoupment occur in the same market where predation occurs?

The Chairman then addressed whether recoupment should have to take place in the market where predation occurred for a violation to occur. The US contribution states: “American Airlines” investment in predatory foreclosure was... designed to deter future entry on numerous other “out of market” routes. [S]ignificantly most of the recoupment would have come from markets other than the ones in which the acts of predatory foreclosure took place.” The Chairman asked the US delegation to explain why it took that position and why the lower court rejected it.

A US delegate responded that American Airlines’ documents suggested that its behaviour was motivated not only by the expectation of affecting the routes on which it expanded capacity, but by the desire to deter entry on other routes, as well. DOJ staff determined that even if lower cost carriers exited the five or six routes at issue, that alone would not have generated enough profit to cover the cost of the capacity that was shifted to those routes. Therefore, out-of-market recoupment seems to have been part of American’s plan. However, the lower court essentially rejected the notion of incremental capacity as a device for predatory foreclosure. The judge appeared to want to make the case fit into a textbook notion of predatory pricing in which price is lower than cost on a market-wide basis. It is arguable that at the appellate level, the Department’s position (based on incremental additions of capacity as the device for foreclosure and out-of-market recoupment) was not rejected by the court of appeals. Therefore, the same type of argument is potentially available for future cases.

The Chairman noted that the UK submission seems to support the DOJ’s position because it states that “it would be wrong to require a showing of recoupment in the same market, for predatory pricing can be anti-competitive and anti-consumer by deterring competition in other markets in which the dominant firm operates”. He invited the UK delegation to expand on its statement.

A delegate from the UK stated that part of the economic theory of predatory behaviour concerns predation for the purpose of establishing a reputation for aggressively responding to entry. In one case, *Aberdeen Journals*, OFT did not make an issue of recoupment in its court filings because EU precedent does not require it, but there was nevertheless good evidence in support of recoupment by way of acquiring a predatory reputation.

Another UK case was *Napp*, which involved a combination of drug pricing far below any measure of cost in the hospital segment of the market and extraordinarily high drug pricing in the wider community. That created

virtually simultaneous recoupment because the hospital sector was a gateway to the wider market where profits were higher.

9. The Air Canada case

The Chairman commented that a number of contributions discuss airline cases. One interesting case arose in Canada, whose Competition Act has both criminal and non-criminal abuse of dominance provisions that cover anti-competitive low pricing. In addition, there is a specific component in Canada's competition laws to address allegations of predatory conduct in domestic airline services. He asked why such specific legislation was necessary, and whether the Air Canada case could have been dealt with under the criminal provisions.

A Canadian delegate replied that the airlines-specific legislation was necessary because of a 1999 merger that gave Air Canada a domestic market share of 90 per cent after it acquired a failing firm. The legislation addressed the Competition Bureau's concerns about the merger by proscribing a long list of anti-competitive acts, including operating or increasing capacity on a route for which prices do not cover avoidable costs.

The government's case against Air Canada involved allegations that the airline had abused a dominant position by responding to the entry of two new low cost carriers on certain routes by increasing capacity or decreasing fares such that Air Canada was not covering its avoidable costs. Phase 1 of the legal proceedings concerned questions about the avoidable cost test. Phase 2 would then address whether Air Canada actually violated the abuse of dominance provision. The Competition Tribunal decided in Phase 1 that almost all airline costs are avoidable. Ultimately, Air Canada failed the avoidable cost test. In the meantime, however, Air Canada filed for bankruptcy so Phase 1 was stayed and Phase 2 is in abeyance. The delegate also said that bringing the case under the criminal provisions would not have worked well because the criminal standard of proof, i.e., "beyond a reasonable doubt", is so high.

10. Non-price predation

The Chairman then delved more deeply into the topic of excess capacity expansion, noting that Germany's contribution includes a case involving that conduct in the cement industry. He asked the German delegation to present the case.

The delegate from Germany first added to the information he gave earlier regarding the Wal-Mart case. He said that in fact a recoupment test was used in that case. The defendants had reduced the prices for several food items, especially basic products like sugar and milk. This price-cutting would have led to a more concentrated market if small and medium size competitors were

squeezed out. The amount of money that an average household spends on those low-priced products is less than one per cent of the total amount it spends each month. Therefore the Bundeskartellamt reasoned that if the market became concentrated, then the discounts might not only have the eventual effect of raising prices for the previously discounted products, but also for the other three thousand items in the stores. Thus it would have been easy to recoup the losses from selling below cost.

With respect to the cement case, the delegate said that predatory pricing and predatory capacity expansion often go hand in hand because higher capacities often result in lower prices. Therefore predatory capacity expansion can be assessed like predatory pricing, and this is most obvious in cases where capacity is excessively added only for the purpose of preventing competitors from using the assets. The Bundeskartellamt dealt with such a case in the proposed acquisition of Malik Baustoffe by Heidelberger Zement. Heidelberger is the largest cement player in Germany. Malik was importing cement from other countries. Heidelberger wanted to purchase the assets of Malik not in order to use this additional capacity but rather to prevent competitors from using it. Thus the sole purpose of the acquisition was to block actual and potential competition. It would also have strengthened the dominant position which Heidelberger held in southern German markets. The Bundeskartellamt prohibited the acquisition in July 1988 on grounds of merger control as well as on grounds of Section 1 ARC.

The Chairman returned to the US contribution, which presents a number of non-price “cheap exclusion” cases. He asked the US delegation to provide more details about the various types of cheap exclusionary practices and how competition agencies can assess them.

An American delegate noted that in *American Airlines*, the company's chief executive officer had remarked that predatory pricing is very expensive. Most firms would prefer a cheaper way to exclude competitors, so predatory pricing is really a last resort rather than a first resort. The delegate said that some forms of cheap exclusionary conduct are efficiency enhancing, as well, like exclusive dealing. But the Federal Trade Commission has focused on conduct in which there is no plausible efficiency enhancing defence. For example, the FTC brought a case against Unocal, a petroleum firm in California. Unocal participated in setting regulatory standards for gasoline in California. The FTC alleged that Unocal claimed that certain relevant intellectual property had been put into the public domain and, in reliance on that claim, California incorporated the technology into its regulations. Afterward, however, Unocal revealed that it had patents covering that technology and proceeded to obtain royalties from other firms who had to comply with the regulations. Lying is extremely cheap conduct, and it does not appear to have an efficiency justification.

The delegate noted that the FTC has brought many cases of that kind. She recommended that since cheap exclusion costs so much less than predatory pricing, it is a good idea for agencies to go looking for such cases because there are probably many of them waiting to be discovered.

The Chairman then invited Mexico to discuss its case against Coca Cola regarding exclusivity contracts in the soft drink market.

A delegate from Mexico explained that the Federal Competition Commission investigated exclusivity contracts because it appeared that Coca-Cola was selling its product on the condition of not using or marketing goods produced, processed, distributed or sold by a third party. Coca-Cola also granted discounts to retailers conditioned on the exclusive distribution or commercialization of Coca-Cola products.

The relevant market was defined as carbonated drinks in the national territory. The FCC determined that Coca-Cola had substantial market power with a share above 70 per cent; Pepsi Cola was the second largest competitor with a share of 18 per cent. The two main distribution channels for carbonated drinks were grocery shops and supermarkets, hotels, restaurants and similar establishments. Advertising and brand positioning were important barriers to entry in addition to retail space restriction caused by the contracts under investigation.

The FCC found that Coca-Cola's exclusive contracts were deterring entry into the relevant market. Pepsi-Cola also used exclusive contracts, but it lacked substantial market power. Therefore, the FCC decided that Coca-Cola was responsible for carrying out relative monopolistic practices that violated Article 10. The FTC ordered Coca-Cola to stop participating in any agreement, program or commercial strategy granting discounts, prizes or promotions tied to promises to sell Coca Cola products exclusively.

The Chairman then asked the New Zealand delegation to present a similar case, *Fischer and Paykel vs. Commerce Commission*.

A delegate from New Zealand said that Fisher and Paykel (F&P) was a manufacturer of whiteware products (i.e., major household appliances). It had an 80 per cent share of the retail market. 55 per cent of whiteware retailers stocked F&P products and accounted for 75 per cent of all retail whiteware sales. F&P used exclusive dealing contracts to prohibit the retailers from stocking its rivals' products. F&P applied to the Commerce Commission for authorisation for these arrangements.

The Commission had to consider two issues. The first was whether the contracts had the effect of substantially lessening competition in the market for the distribution and sale to retailers of whiteware goods in New Zealand. The second was whether the efficiency benefits outweighed any anti-competitive detriments.

A majority of the Commission found that there was a substantial lessening of competition arising from the arrangements that was not outweighed by benefits. It also concluded that F&P had significant market power and that a large fraction of the retail market was foreclosed. Furthermore, the arrangements had deterred significant entry or expansion in the retail market and caused competitors' costs to increase as they were forced to open new retail outlets. In contrast, the minority found no substantial lessening of competition because the contracts did not exclude rivals from the market altogether, but only from some outlets. Moreover, entry was not difficult because retail space could easily be obtained and there were no significant sunk costs. The minority concluded that the contracts increased distribution efficiencies and prevented rivals from free-riding on F&P's reputation.

On appeal, the High Court identified recent trends in US case law favouring a finding that vertical restraints were pro-competitive in all but exceptional cases. The High Court also found low barriers to entry and identified efficiencies flowing from the arrangement. Consequently, it upheld the minority's decision.

The Chairman then opened the floor for general discussion.

A delegate from France commented that when considering foreclosure – whether through pricing or other means – it is important to move towards a broader approach where economic efficiency gains would be taken into account. He added that in the ongoing debate in France on retail pricing in large stores, three elements should be kept in mind:

- if we move toward an analysis that takes efficiency gains into account, this should not affect the predictability of enforcement measures. What is striking in the debate in France is that businesses are requesting not only that the pricing rules be eased, but that they be clarified. In fact, they would rather see more predictability in the rules than very strong deregulation. So there should be a checklist that is applied predictably. The delegate added that courts also expect clear, predictable rules, as it is hard for them to understand why they should punish pricing practices that are beneficial to consumers;
- the efficiency gains should be accurately measured, notably as regards consumers;
- the efficiency gains should be assessed within a relevant timeframe because although they may be beneficial to consumers in the short run, they may be less so in the longer run.

A delegate from Spain remarked that the Spanish competition authority has had several predatory prices cases, but most of them have been rejected. A recent one had to do with the market for cigars, which was formerly controlled by a state owned monopoly. The former SOE reduced its prices, thereby excluding a competitor, and then raised its prices after the competitor was

expelled. It was a clear cut case of predatory pricing and recoupment, and the company was sanctioned by the Tribunal.

The delegate also made three points. First, having a dominant position is a requisite for concluding that there is predation, and it is irrelevant whether this dominant position has been acquired through market competition or through legal barriers to entry. Second, it is much easier to bring a case in which recoupment has already occurred than it is to prove future recoupment. Of course, if one must wait for actual recoupment then it may be too late because the competitors have already been driven out of the market. Third, it can be very difficult to identify the relevant cost to compare with prices. It is especially difficult when there are selective rebates or tying and bundling strategies.

Predatory Foreclosure

4. Country Contributions

Further information from the following jurisdictions on the topic of Predatory Foreclosure is available at: www.oecd.org/competition under the topic “Best Practice Roundtables”.

Country contributions

Canada	Norway
Denmark	Switzerland
Germany	Turkey
Japan	United Kingdom
Korea	United States
Mexico	European Commission
New Zealand	Chinese Taipei

Resale Below Cost Laws and Regulations

Despite general agreement that consumers benefit from lower prices that are not predatory, several nations have laws against loss leader sales even when they are unlikely to foreclose competition. These laws appear to protect competitors rather than competition. The Competition Committee's roundtable discussion in October 2005 focused on efforts to reform or remove laws against loss leader sales and efforts to prevent such restrictions from being enacted. The Secretariat background note argued that rules against loss leader sales should be sunsetted because they are likely to harm consumers and protect inefficient competitors, fail to account adequately for pro-competitive business justifications for loss leader sales and detract from economic dynamism and growth. Japan, Germany and France, defended their rules against price competition, although France was in the process of a reform. Members of a second group of countries were working to remove laws against loss leader sales. The nations in a third group with no law against loss leader sales, reported efforts by groups of competitors to have such rules applied either at the national level or at the state/provincial level. Both the consumer and business submissions argued that prohibiting loss leader sales is likely to harm consumers and protect competitors, rather than competition.

Resale Below Cost Laws and Regulations

1. Synthesis by the Secretariat

Synthesis by the Secretariat

Considering the discussion at the roundtable, the delegates' submissions and the background paper, several key points emerge.

1. Resale-below-cost (RBC) laws that serve to protect high-price, low-volume retailers from low-price, high-volume retailers, are a battle ground between contrasting visions of competition policy

Competition authorities and economists generally agree that improving consumer welfare should be the main objective of competition policy. But competition authorities and public policy makers around the world face pressures to protect competitors rather than competition. Protecting competitors is likely to benefit selected suppliers at the expense of consumers and impede innovation, efficiency, and employment gains. RBC laws are often promoted explicitly to protect low volume, high price suppliers, notably small retailers. Protecting competitors is generally inconsistent with protecting consumers because protecting competitors limits competition and is likely to increase prices.

RBC laws are a topic for ongoing debate in most countries. Although two national competition authorities support such laws, most do not. Authorities which oppose RBC laws report mixed success in discouraging their enactment. Ireland is an example of a nation whose competition authority is strongly advocating an end to prohibitions on RBC sales (under the present Groceries Order). Even where RBC laws have been revoked or turned down at the national level, provincial or state governments have often enacted RBC laws. Sometimes these sub-national statutes or regulations apply only to one specific industry or are interpreted fairly liberally, however, the potential for intrusive RBC laws remains.

2. The claimed benefits of RBC laws for consumers appear to be 1) already provided by other laws, 2) economically dubious, and 3) empirically unsupported

An analysis of the costs and benefits of RBC laws for consumers starts with the basic proposition that consumers benefit from lower prices unless the lower prices cause higher prices later, deceive consumers or prevent suppliers from offering complimentary services that benefit consumers more than the lower prices. In many markets, none of these exceptions appear to apply. Predatory foreclosure laws more accurately identify low prices that can reduce competition and allow a predator to recoup its losses after lessening

competition. (RBC laws do not separate out low prices that are likely to harm competition from low prices that benefit consumers.) Consumer deception laws deal with misleading marketing practices involving loss leader pricing. For new or complex products, manufacturers can develop methods to compensate retailers for providing services, provide the information directly to consumers or induce customers to pay for such services. Consumers may not want additional services for familiar products.

3. *RBC laws do not prevent declines in the market share of high price, low volume retailers. Nations without RBC laws continue to have a variety of retailers including small, localized retailers*

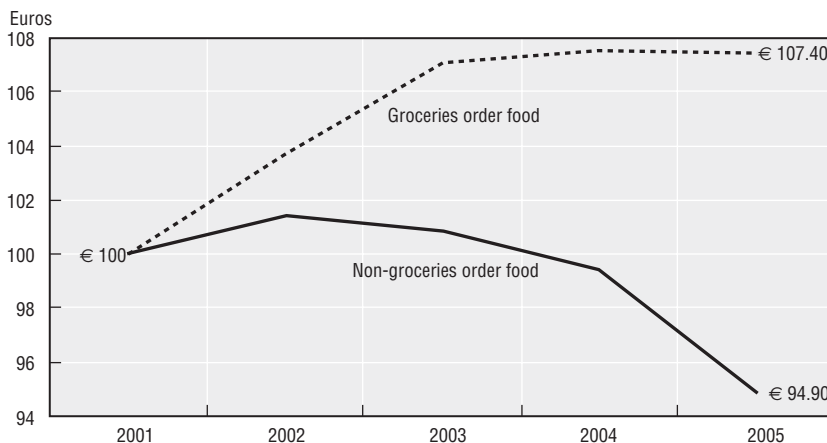
A claimed benefit of RBC laws is preservation of small local retailers that some consumers may prefer because of they are conveniently located and often provide personalized service. Studies of the retail sector indicate that the presence of RBC laws does not prevent a shift in retailing towards high-volume, low-price retailers and that areas without RBC laws continue to have a variety of retail outlets. Even though large retailers are generally growing relative to small retail, small outlets do not appear to be in any danger of disappearing and entry of new small outlets can take place where consumers are particularly interested in this type of outlet. If the policy objective of RBC laws is to preserve small retailers in specific locations, there are likely to be more effective, better targeted and less costly approaches than RBC laws. Further, some survey evidence suggests that small stores are just as likely as large stores to find it advantageous to offer RBC prices as a marketing tool in order to generate store traffic.

4. *The concerns about the costs of RBC laws for consumers appear to be economically sound and empirically supported. First and foremost, RBC laws are likely to result in consumers paying higher prices*

The Irish Competition Authority examined pricing trends under the Groceries Order, Ireland's RBC law. The Authority found the prices for grocery store items covered under the Order have been increasing, while prices for grocery store items not covered by the Order have been decreasing. The graph created by the Irish Competition Authority is reproduced below. On average, Irish families are paying 500 euros more per year for covered items because of the Order. Further, the burden is disproportionately high for low-income families because covered items are a higher proportion of their total expenditures.

Collaborative evidence about the effects of low-price, high-volume retailers on retail prices in general comes from the experiences on Guam and Hawaii when this type of retailer first entered these geographically isolated areas. Both areas experienced general and sustained retail price declines of approximately 15%.

Figure 1. **Food covered by Groceries Order rises in price while food not covered falls**



Source: Retail food prices June 2001-June 2005 – from CSO data.

5. RBC laws can arbitrarily increase costs of low-price, high-volume retailers

The loss leader sales that RBC laws prevent are a common form of marketing in countries that do not have RBC laws. There are numerous legitimate business justifications for loss leader sales. Many of these concern conveying information to consumers about products or retailers by encouraging consumer to try an unfamiliar product or visit an unfamiliar retailer. Another potentially important beneficial effect of loss leader sales is to compensate customers for their switching costs. Loss leader sales can also speed learning curve effects for a manufacturer (leading to lower production costs). In short, loss leader sales can be one of the most cost effective marketing tools available to low-price, high-volume retailers. When RBC laws prevent loss leader sales, they force such retailers to adopt higher cost marketing techniques, thus reducing incentives to enter. When high-price, low-volume retailers successfully advocate enactment and enforcement of RBC laws, they effectively raise their rivals' costs. Customers of the low-price, high-volume retailers will, as a result, pay higher prices because these retailers face higher costs and there are fewer such outlets available to serve consumers who prefer this retailing approach.

It is interesting to note that RBC laws are applied against loss leader pricing of individual products within the much broader cluster of products that retailers typically offer. However, when competition authorities analyze mergers in the retail sector, they generally apply some type of cluster market analysis that seldom deals with the pricing of individual products.

6. *RBC laws are likely to discourage price competition by undermining consumer incentives to search for bargain prices. When consumers actively search for bargains, competition generally increases because demand is more sensitive to price changes*

A key element in competition is the degree to which consumers search for lower prices and switch to retailers that offer lower prices. Consumers generally undertake search activity to the extent that it is worthwhile to do so. Search activity is rewarding when there is more price dispersion because when prices differ substantially between retailers, the expected benefit (finding a lower price) of searching is greater. One of the effects of RBC laws is to cut off the lower part of the distribution of prices – no more loss leader prices. Consequently, imposition of RBC laws is likely to cause consumers to curtail their search activity. This in turn will make it easier for retailers with high prices to obtain sales and it may allow retailers to profitably raise prices above the competitive level because consumers have become less likely to switch to other retailers in the face of higher prices. In addition, legal restrictions on low prices may make it easier for sellers to monitor compliance with a collusive price agreement because the government enforces restrictions against unusually low prices. Similarly, lack of loss leader sales can result in less pressure on manufacturers to offer discounts because retailers face fewer extremely low prices that prompt them to seek price concessions from suppliers.

7. *RBC laws are associated with slower economic growth and higher unemployment*

Numerous OECD studies have found that high levels of regulation, including RBC laws, are statistically associated with slower economic growth and higher unemployment. By curtailing a potentially effective and important marketing tool for new types of retailers, RBC laws are part of the cluster of retailing regulations associated with slower growth in both sales and employment. To the degree that lower skill workers commonly enter the workforce through retailing jobs, the effects of slower growth in the retail sector may fall disproportionately on lower skilled workers.

8. *RBC laws can create excessive incentives for firms to vertically integrate*

RBC laws also can cause economic inefficiencies by distorting incentives for firms to vertically integrate. A firm that finds that loss-leader pricing is its most cost-effective marketing strategy in a country with RBC laws may have incentives to excessively vertically integrate in order to legally offer prices that would have violated RBC laws if the firm was not vertically integrated. RBC laws may not apply to vertically integrated firms (they are not resellers) or the standards applied may be less restrictive or violations may be more difficult to detect and document.

9. *RBC laws are difficult to enforce effectively and equitably. This can lead to high administrative costs and regulatory risk*

RBC laws present significant administrative challenges. One difficulty is distinguishing transaction prices from invoice prices or invoice prices adjusted for selected discounts and allowances. France has been working to move its definition of price closer to the transaction price following a period of relying on the invoice price that resulted in pricing distortions. France has also observed that RBC laws may be used as a close substitute for retail price maintenance (RPM), a practice that French law generally forbids.

10. *Given the weak evidence on benefits and the strong evidence on costs to consumers of RBC laws, nations have ample justification to reexamine these laws through a sunset review process*

In nations that already have laws against predatory foreclosure and consumer deception, the costs to consumers of RBC laws are likely to exceed the benefits. In addition to direct costs to consumers from higher prices, RBC laws are likely to increase the costs of low price, high volume retailers, discourage customer search behavior, distort investment decisions and impede dynamic economic growth in the retail sector and wherever else RBC laws are in force. An objective sunset review can be used to confirm that these general, negative relationships between consumer welfare and RBC laws hold true in a particular country.

Resale Below Cost Laws and Regulations

2. Background Note

Background Note

by

John Hilke*

1. Introduction and summary

Resale-below-cost (RBC) laws are one of three major types of regulatory restrictions on resale prices. The other two types are predatory foreclosure laws and mandatory minimum resale price maintenance (RPM) laws.¹ The focus of this paper is on RBC laws and the effects of these laws on consumer welfare and economic efficiency. RBC laws usually forbid loss leader sales – resale prices that fall below the price the reseller paid for the product. Variations include minimum acceptable markups over acquisition costs and adders for transportation or other costs. Analysis of RBC laws, often touches on the predatory foreclosure and RPM laws because they share some related economic rationales, are all applied to resellers and can serve as partial substitutes for each other.

The conclusion of this paper is that RBC laws are more likely to harm consumers² than to benefit them. RBC laws do not fit well with the consumer welfare and economic efficiency paradigm, especially where laws against predatory foreclosure are also in place. Instead, RBC laws take a per se approach against price cutting that is likely to protect resellers that adopt a high-price/low-volume strategy against competition from resellers that adopt a low-price/high-volume strategy. RBC laws do not require any demonstration that current low prices will lead to higher prices later – they just assume such a relationship. RBC laws appear to inhibit growth and innovation by low-price/high-volume resellers that can benefit consumers and bring efficiencies and economic growth in the retail and manufacturing sectors. RBC laws do so by restricting “loss leader” sales that may be a legitimate, efficient, and important marketing tool for low-price/high-volume resellers. Another economic concern is that stringent RBC laws can contribute to regulatory stagnation that has been linked to slower economic growth and higher unemployment rates. From

* This note was prepared by John Hilke, Consultant to the OECD Secretariat.

a consumer welfare and economic growth perspective, RBC laws are good candidates for “sunset” reviews by OECD member countries.

Although RBC laws are commonly perceived as a type of competition law, they actually may have objectives other than consumer welfare and economic efficiency. When this is the case, enforcement of genuine competition laws may be diluted and public understanding and support of competition laws and their enforcement may be undermined. Enforcement of genuine competition laws may be reduced because the responsibility of competition agencies to enforce a law with other objectives may not be accompanied by commensurate additional funding. Public understanding and support of competition laws may be undermined because inclusion of non-competition laws within the body of competition laws makes the latter appear to be inconsistent or contradictory. Further, understanding and support for competition laws may be undermined if some of the consumer welfare and efficiency costs associated with enforcing RBC laws are mislabelled and attributed to competition laws.

This review concludes that classifying RBC laws as competition laws is a questionable practice. If one examines the historical roots of RBC laws and other policies that may accomplish similar economic results, it appears that RBC laws have much in common, and perhaps more in common, with laws regarding historic preservation, land use and social externalities. If RBC laws are to be maintained, perhaps the most attractive alternative is to classify them outside of competition laws, but establish the authority of the competition agency to intervene when enforcement of RBC laws is harming competition.

The key points of this paper are:

- RBC laws are one of three constraints on resale prices that governments sometimes enforce or allow. RBC laws outlaw loss leader retail sales. The other common resale pricing restrictions are predatory foreclosure laws and RPM.
- RBC laws are more likely to harm consumers than to benefit them. RBC laws contravene the general economic conclusion that consumers benefit from lower prices. The exceptions of predatory foreclosure, free riding and consumer deception require nuanced economic evaluations that are difficult to reconcile with RBC laws.
- There are a wide variety of legitimate business justifications for RBC transactions (loss leaders). Several of these involve conveying information to consumers that can improve consumer welfare. One of the most deleterious effects of RBC laws is to reduce the dispersion of resale prices. This causes consumers to engage in less search activity and, consequently reduces the future price sensitivity of demand. When demand is less price sensitive, resellers may have increased opportunities to exercise market power.

- There is evidence that consumers do pay more when goods are subject to RBC prohibitions. In Ireland, for example, the Groceries Order is estimated to raise the food bill for the average family by almost € 500 per year.
- RBC laws raise three other concerns: horizontal unfairness between different types of resellers, potential for raising rivals' costs (cheap exclusion) and distortions in vertical integration decisions.
- RBC laws may blunt incentives for resellers to aggressively pursue efficiencies and innovations at the manufacturing level. This may reduce efficiency and innovation at that level in the chain of production.
- RBC laws are likely to contribute to regulatory stagnation that leads to slower economic growth and higher unemployment rates.
- RBC laws are good candidates for "sunset" reviews in OECD member countries, particularly if laws against predatory foreclosure are in place.
- RBC laws appear to have effects that more closely resemble historic preservation, land use or social externalities laws rather than competition laws.

The analysis proceeds in four major sections in addition to the introduction and conclusion. Section II examines RBC laws from a consumer welfare and economic efficiency perspective. Section III considers the likely effect of RBC laws on retail dynamics and economic growth. Section IV reviews trends in RBC laws. Section V discusses alternative policy classifications for RBC laws.

2. RBC laws from a consumer welfare and economic efficiency perspective

The starting point for analysis of RBC laws in this paper is the widely accepted proposition that competition laws should benefit consumers and generally enhance economic efficiency.³ This was a point of consensus among the delegates at the October 2004 OECD roundtable on predatory foreclosure. Despite this apparent consensus among competition law enforcement agencies, there is a risk that special interest will capture the legislative process and promulgate pseudo-competition laws that instead protect favoured suppliers. This risk can arise, for example, when consumer interests and those of potential entrants are underrepresented in the political process because it is more difficult to organise such diffuse and diverse groups.⁴ An evaluation of the consumer welfare effects of a law can be a useful litmus test to separate real competition laws from pseudo-competition laws.⁵

2.1. Lower prices generally benefit consumers

Consumers generally benefit when suppliers lower their prices. Beneficial income and substitution effects are both likely to be present. When the price of

Box 1. **Typology of restrictions on resale prices**

If the three forms of government restrictions on resale prices are ranked by the degree to which they restrict resale prices, RPM laws are likely to be most constraining, RBC laws occupy the middle position and predatory foreclosure laws are generally the least constraining because they usually entail a recoupment test as well as a price test alone.

These three government restraints on resale prices also differ with respect to who establishes the legal price standard and whether it is firm specific. RBC price standards are generally determined and enforced by government agencies. The RBC price floor is specific to each product sold by each individual reseller based on its costs of acquiring a particular product for resale. Predatory foreclosure price standards are also generally determined and enforced by government agencies. The predatory price standard is also specific to the seller and the product. Prices below the predatory standard are not violations, however, if recoupment is unlikely. The RPM price floor is a specific figure that does not generally vary between resellers in the same geographic area. RPM may be government enforced or it may be privately enforced through the terms of supply contracts.

The three types of restrictions on resale prices are generally imperfect substitutes for each other. For example, RBC laws could prevent one of the most severe concerns associated with free riding – using a product subject to free riding as a loss leader. But RBC laws would not apply to less severe forms of discounting. In contrast, RPM price floors generally are well above acquisition costs of resellers. That is because in order to encourage intra-brand competition in the form of additional services and avoid free riding, the difference (margin) between the minimum resale price and the acquisition costs must be sufficient to compensate resellers for providing the desired services.¹

It is hazardous to state any general economic conclusions about vertical restraints, which include RPM. Perhaps one way to do so is to state that vertical restraints are least likely to raise economic objections if the creation, monitoring, and enforcement of vertical restraints are left to each manufacturer; if there is no evidence that resellers have coerced the manufacturer or orchestrated enforcement; if consumers all generally need or want the same substantial level of service; and if the vertical constraint does not have anticompetitive horizontal effects. This represents a shift from either the view that all vertical restraints are anticompetitive or the view that the government should subsidise or take over enforcement of private vertical restraints. It mirrors the shift in merger enforcement toward viewing most vertical mergers as benign. The policy debate continues around types of

Box 1. Typology of Restrictions on Resale Prices (cont.)

vertical restraints that may have anticompetitive effects akin to horizontal restraints.² Interestingly, several of the discussion of the policy debates in member countries concerning RPM in the 1997 roundtable included indications that the primary supporters of allowing RPM in books and newspapers were competitors likely to have higher prices and costs, but not services that all consumers want.

1. For a second example, stringent RBC laws are likely to prevent only a portion of prices that could involve predatory foreclosure because a reseller's acquisition costs are often only one component of the variable cost or marginal cost price floor involved in predatory foreclosure analysis. However, RBC laws could prevent a portion of resale prices that exceed the threshold for predatory foreclosure or that would be exempted from the predatory foreclosure laws because recoupment is unlikely. Similarly, RPM price floors would generally prevent predatory foreclosure but would exclude many prices that are unobjectionable under predatory foreclosure laws.
2. See William S. Comanor, F.M. Scherer, and Robert L. Steiner, "Vertical Antitrust Policy as a Problem of Inference: The Response of the American Antitrust Institute," available at www.antitrustinstitute.org/recent2/408.pdf; James C. Cooper, Luke M. Froeb, Dan O'Brien and Michael G. Vita, "Vertical Antitrust Policy as a Problem of Inference," Federal Trade Commission Bureau of Economic Working Paper (November 8, 2004, revised 18 February 2005) available at www.ftc.gov/speeches/froeb/050218verticalecon.pdf; John Woodbury, "Paper Trail: Working Papers and Recent Scholarship", (May 2005), available at www.abanet.org/antitrust/source/05-05/may05-papertrail.pdf; Thomas R. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Federal Trade Commission Staff Report (November 1983).

a product declines, consumers can obtain more of the product for the same amount of money; or they can buy more of other products and services (or add to savings) if they purchase the same quantity of the reduced-price product; or consumers can simultaneously purchase a little more of both the low-priced product and other products. Some consumers may stock up on a low-priced product and consume it gradually. Others may immediately consume more of a low-priced product because they are buying fewer higher-priced, substitute products. Some consumers may view the lower price as an opportunity to try out a product that they have not tried before or cannot usually afford. Low prices can encourage consumers to visit a retailer they had not previously patronised. Some consumers may stock up on low-priced items in order to supply friends or family in geographic areas where there has been no price decrease (arbitrage).

Some consumer responses to lower prices may result in changes in long-term buying behaviour because consumers have discovered that the reduced-price product or outlet better matches their preferences. When consumers have benefited from instances of lower prices, they may become more price conscious in general.⁶ This can lead to savings for these consumers and to overall consumer demand that is more price sensitive (elastic). When customer

demand is more price sensitive, it is more difficult for sellers to profitably raise prices above the competitive level (exercise market power).

All of these variations in consumer responses to lower prices provide benefits to consumers by allowing them to consume more of one or more products. Many of the consumer effects of reduced prices can also lead to increased competition at the retail level and then to increased competition at the wholesale and manufacturing levels. Additional benefits may accrue to consumers when retailers, wholesalers and manufacturers are forced to pass along efficiencies that are prompted by increased competition and demand that is more sensitive to price changes. Therefore, the economic starting point for economic evaluation of RBC laws should be that lower prices benefit consumers regardless of whether the new prices are above or below resale costs.

In markets with imperfect information, lower prices offered by some suppliers may have important consumer welfare and efficiency benefits beyond their immediate effects. These future benefits stem from the positive effects of current price dispersion on future consumer search behaviour.

If RBC laws reduce the price dispersion among retail distributors by restricting the number and frequency of unusually low prices, they may lead to less consumer search activity.⁷ This will then cause a decrease in the price sensitivity (elasticity) of demand and increased opportunities for retail distributors to exercise market power by raising prices. RBC laws may teach consumers not to expect low prices and this becomes a self-fulfilling prophecy.

The price elasticity of demand is an important element in assessing market power. An important element in the price elasticity of demand is customer search activity. When customers actively search for lower prices, sellers attempting to raise prices above the competitive level will find it less profitable to do so because consumers are more likely to seek out and buy from sellers offering lower prices. However, active consumer search is not a given. Like other activities, consumers are more likely to engage in search activities if doing so is more likely to be rewarding. The reward is finding lower prices. Consumers are less likely to search for lower prices if they believe that the chances of finding lower prices are scant. This in turn leads to less consumer search and subsequently to a higher probability that a seller offering prices above the competitive level will make sales and find this to be a profitable pricing strategy. This model of consumer behaviour is sometimes referred to as the “tourist trap” model.⁸ Without coordination among sellers, it is difficult to prevent other sellers from offering unusually low prices to attract customers. This creates incentives for future active consumer search for these unusually low prices and makes it less profitable to raise prices above

competitive levels. There is another way, however, for one or more high-price sellers to succeed in stifling consumer search and that is to enlist government help in the form of prohibitions against unusually low prices. By eliminating unusually low prices, active consumer search becomes less likely in the future and opportunities for sellers to exercise market power consequently increase. RBC laws fit this pattern.

2.2. The predatory foreclosure exception

The May 2005 OECD roundtable on predatory foreclosure focused on a prominent potential exception to the economic proposition that consumers benefit from lower prices. The exception occurs if a supplier uses strategies that would not make economic sense in the short run in order to reduce future competition and, thus, enable it to exercise increased market power in the future. In such a situation, consumers can be harmed if the present value of future higher prices exceeds the present value of lower current prices.⁹ This exception involves two principal elements: 1) prices are abnormally low; 2) future prices will be above the competitive level as a result of the current abnormally low prices. This can occur if rivals are driven out of the market or they are sufficiently disciplined so that the predator can subsequently exercise market power sufficient to recoup the losses from its predatory pricing or other tactics. Entry must also be impeded if recoupment is to take place. If either element is missing, consumers are likely to benefit from abnormally low prices. In the case of raising rivals' costs predatory foreclosure (as opposed to predatory pricing), the firm increases its own costs because doing so will disproportionately increase the costs of its rivals and allow the firm to exercise increased market power in the future. Raising rival's costs can drive rivals out of business or weaken their ability to compete. In turn, this can increase the firm's ability to exercise market power, if entry is impeded.

The country submissions to the predatory foreclosure roundtable establish that there are diverse views about what constitutes an abnormally low price (or other firms if strategic behaviour), and about what evidence is required to demonstrate that exercise of market power will increase in the future (recoupment) as a result of abnormally low pricing. However, the general framework, with the two elements, is widely accepted in the economic literature and by participants in the predatory foreclosure roundtable.

Item 10 from the predatory foreclosure roundtable summary warrants special attention because it points to the potential "capture" of government policy instruments that are akin to vertical restraints in order to reduce competition. Examples could include curtailing marketing practices that are advantageous for one or more competitors or preventing competitors from having access to key inputs. In these examples, a reseller or group of resellers works to reduce competition by exercising political influence over government

Box 2. Summary of the predatory foreclosure roundtable

The key points from the roundtable were:

1. Competition laws and policy on predatory foreclosure should be used to protect competition, not protect competitors.
2. There is no consensus on the best cost benchmark to use in predatory pricing cases, or even on whether an ideal measure exists. Although the average avoidable cost test is gaining support among scholars and practitioners, several delegates express a preference for maintaining enough flexibility to tailor the cost measure used to the facts of each case.
3. A dominant firm's price may be considered predatory in some jurisdictions even if it is above all measures of the firm's own costs.
4. The recoupment test should be routinely applied in predatory pricing cases.
5. Many competition agencies now take recoupment into account in predatory pricing cases, even if the law in their jurisdiction does not require them to do so. Agencies should be mindful, however, that testing for dominance is not equivalent to doing a recoupment analysis.
6. Because of reputational effects, recoupment does not have to take place in the same market in which predation occurs.
7. Below-cost pricing – even by dominant firms – is not always predatory. Competition authorities should take into account any legitimate business justification offered by alleged predators.
8. The “meeting competition” defence is recognised in many jurisdictions, but its rationale is not entirely sound and it can be difficult to apply in the presence of non-price competition.
9. Several lessons about law enforcement methods against predation may be learned from recent cases brought against airlines.
10. Not all predatory behaviour involves pricing strategies. Companies may also use “cheap exclusion” tactics to eliminate and deter competition.

policy. Because there is no period of losses (as there would be with predatory pricing) associated with exclusion by means of capturing government policy, it can be termed “cheap exclusion”.

Another potential concern is the equivalent of predatory foreclosure by a monopsonist or a group of resellers that form an oligopsony. Monopsony (buyer) power over manufacturers by large resellers is the concern sometimes raised in defence of RBC laws. Monopsony, like market power of a seller, is associated with concentrated ownership (in this case, among buyers). Monopsony power over suppliers could take the form of uniformly below-market

prices for all buyers or of below-market prices offered only to selected buyers. The result of below-market prices due to monopsony power could be displacement of efficient downstream competitors by rivals with upstream monopsony power as well as reduced output by manufacturers. Monopsony power is exercised by reducing the price paid to manufacturers below the competitive level.¹⁰

In the long run, displacement of efficient downstream competitors (in the presence of entry impediments) could lead to higher downstream prices that would harm consumers. Monopsony power, under some conditions, could be used by resellers to establish downstream market power. For monopsony power to harm consumers, either the reduced acquisition costs are not passed on to consumers, in which case RBC laws would have no effect, or there must be a recoupment element similar to that in predatory pricing analysis. If a retail monopsonist secures unusually low prices from a manufacturer, and it uses these lower costs to drive out its downstream competitors, consumers benefit from the lower prices unless in subsequent periods the monopsonist can exercise monopoly power at the retail level. Therefore, entry conditions and competition between resellers with monopsony power can be important considerations in assessing whether monopsony power of one or more resellers is likely to increase or decrease consumer welfare.

It can be difficult to distinguish price pressure on manufacturers due to vigorous downstream competition from exercise of monopsony power by one or more downstream competitors. Making this distinction requires careful consideration of the likelihood that horizontal downstream market power will be enhanced as a result of low prices offered by manufacturers.¹¹ The other important consideration is whether there is existing market power at the manufacturing level. If so, countervailing monopsony power may enhance competition and benefit consumers. These potential considerations suggest that a full competition analysis is appropriate in addressing monopsony market power concerns. RBC laws contain none of the nuances involved in such an analysis.¹²

Taking the predatory foreclosure framework as a point of reference, there are two major questionable aspects of RBC prohibitions. First the RBC price standard may differ from the “abnormally low” pricing or strategic behaviour standard used in predatory foreclosure analysis. Second, there is no requirement in RBC laws that current RBC transactions result in future prices that are above the competitive level (market power). Compared to predatory foreclosure laws (including foreclosure through exercise of monopsony power), RBC laws are likely to involve a high proportion of false positives. From the consumer welfare perspective, that means outlawing a high proportion of low prices that would benefit consumers.

Finally, it is important to acknowledge that a benefit/cost analysis of RBC laws is different in the context of existing antitrust prohibitions against predatory exclusion (or other forms of exclusionary conduct) than it would be if RBC laws stood alone. The incremental effect of the RBC laws consists of the prohibition of behaviour that is not prohibited by the predatory foreclosure laws. This includes all RBC transactions by firms with no prospects for recoupment and RBC transactions of firms that could recoup but that are above the prevailing pricing standard for predatory foreclosure.¹³ The economic concerns are that both types of transactions prohibited by RBC laws are likely to benefit consumers and have legitimate business justifications.

In summary, if a restriction on low resale prices is appropriate because of concerns about predatory foreclosure, the predatory foreclosure laws are preferable to RBC laws because they set a more relevant pricing standard and because they include an analysis of potential recoupment. There are enough complexities in predatory foreclosure matters with respect to both monopoly and monopsony power that more detailed analysis likely is warranted to avoid enforcement errors. RBC laws do not appear to provide a setting for such detailed analysis.

2.3. The Free Rider Exception

One potential interpretation of RBC laws is that they serve as a partial substitute for RPM when RPM is prohibited. RBC laws are like RPM in that they establish a price floor, but differ from RPM in that the RBC price floor is lower on average and uneven (specific to the reseller's acquisition costs). The background note for the 1997 OECD roundtable on RPM¹⁴ summarises the economic arguments in favour of allowing private RPM, and by inference, an argument in favour of RBC laws if RPM is not in place:

RPM, like other types of vertical restraints, may help solve problems of co-ordination between upstream and downstream firms and increase the combined profits available to these firms. Co-ordination problems may exist, for example, over pricing and the provision of retail services. In the case of price, if both the upstream and downstream firm have market power and do not co-ordinate their pricing, there is a possibility that each firm's pricing decision will result in a final price that is "too high", i.e., higher than the profit maximising price for the vertical chain as a whole.¹⁵ In the case of services, there is the possibility that each downstream firm's decision about the provision of services will be sub-optimal for the vertical chain as a whole.

There is a substantial economic literature regarding public policy toward potential market failures due to free riding¹⁶ Also, there have been significant shifts in policy regarding efforts of manufacturers and resellers to prevent free

riding (or perceptions of free riding).¹⁷ Practices and policies such as private RPM, government enforced RPM (“fair trade”), assigned retail territories, refusal of manufacturers to deal with discounters, licensing of retailers (pharmacists for example), legal restrictions on sales without service (prescriptions), restrictions on gray market imports, transshipment restrictions and required disclosures (prescriptions drugs for example) can all be viewed as private or government approaches to maintain services by discouraging free riding.

The 1997 OECD background paper pointed out that vertical restraints (and substitutes for them) have been the subject of considerable controversy because they can act like horizontal restraints on competition that harm consumers.¹⁸ For example, resellers with a high-price strategy may exaggerate the extent of free rider issues in order to convince manufacturers or government that RPM is appropriate or that discounters should be cut off by the manufacturer. Because of the potential for horizontal effects from vertical restraints and concerns about geographic restrictions on commerce from vertical restraints, most OECD countries have banned RPM, subject to a few exemptions regarding books, newspapers, and medications. Recommended prices were generally permitted as long as they are not enforced. This treatment persists, but other forms of vertical restraints are often less severely treated.¹⁹

If there is a legitimate concern about free riding or related market failures, application of minimum-price RPM is more likely to be effective than application of RBC laws. Minimum price RPM could specify prices that provide margins sufficient to compensate for customer service costs of a reseller. If RMP is not in place, RBC laws could cut off some of the severe forms of free riding activity, but RBC laws would generally be only a partial substitute for minimum-price RPM.²⁰

2.4. The deceptive practices exception

In a market economy in which resellers know more about prices and quality than consumers, consumers may be harmed by deceptive practices. Information asymmetries can even lead to the collapse of markets as in the example of “lemons” markets.²¹ Harm to consumers from information asymmetries can occur without being so pervasive that it leads to market collapse. For example, the asymmetry may pertain to only a subset of consumers. In this case, the market, although thinner than it would otherwise be, can function efficiently for informed consumers. From a public policy perspective, many information asymmetries do not warrant intervention because the market will develop its own mechanisms to remedy information asymmetries; even if it does not, the costs of intervention may exceed the benefits. With these caveats in mind, there may be other situations in which government intervention is economically justified. These situations are likely to include

those in which a practice is unambiguously harmful to consumers and harmful behaviour can be objectively determined at relatively low cost by an enforcement agency. A common conclusion of economists and policymakers is that deceptive practices are among the situations in which government intervention is sometimes economically appropriate.

This background raises the question as to whether RBC transactions are deceptive and, therefore, should be banned. In the following section, several examples are presented in which RBC transactions appear to be part of legitimate business considerations that do not require deception to be profitable and that are likely to increase competition and benefit consumers. Therefore, it does not appear that all RBC transactions are deceptive or harmful to consumers. This leaves open the possibilities that some RBC transactions are deceptive and harm consumers while others are not and that, on balance, RBC transactions harm consumers. If the latter is true, a ban on RBC prices might be appropriate. Another possibility is that some RBC transactions deceive consumers, but that these situations can be remedied without resorting to a ban on beneficial RBC transactions.

Three scenarios in which RBC transactions may be deceptive are “bait and switch” sales tactics, “out-of-stock” sales tactics and misleading claims about general price levels. The first two are practices that may occur without RBC transactions, but are likely to be more harmful if RBC price levels are used. All three deceptive practices depend on the expectation that some consumers will be drawn to a resale merchant carrying multiple products primarily because it offers some of these products at RBC prices. The other critical assumption is that not all consumers “walk out” when conditions at the reseller do not meet their expectations.²²

In a bait and switch situation, once consumers are on the premises, some consumers are convinced not to buy the RBC product, but instead they buy products with a high resale mark-up. In an out-of-stock strategy, the reseller stocks less than the quantity demanded at the RBC price and consumers are persuaded to buy a substitute item at a positive resale mark-up. In a misleading general pricing claims scenario, the reseller persuades consumers to come to the outlet based on a claim that the reseller’s RBC prices are representative of its prices in general. Consumers buy a variety of products believing that their outlay will be less than at other resellers when, in fact, their total expenditure will be equal to or higher than at other outlets. There are at least short term profit incentives for resellers to use all three deceptive practices if some consumers behave as expected.

If the market does not develop private remedies for these deceptive practices or such remedies are slow to develop,²³ is a ban on RBC the most appropriate remedy, even if the challengeable assumption is made that

deception is the predominant cause of RBC transactions? RBC laws would not be appropriate based on a deception theory if other remedies short of a ban on RBC transactions are available at comparable costs and if these remedies are less likely to harm consumer welfare and competition than a ban on RBC transactions. At least some competition authorities have concluded that narrower remedies are available and effective. For example, the US FTC has rules against bait and switch sales tactics, and requires “rain checks” (a coupon to buy the product later at the sale price) or equivalent compensation for consumers if an item on sale is out-of-stock and the advertisement failed to disclose that only a limited supply would be available at the advertised price. The FTC also prohibits deceptive advertising of price comparisons or any other material claims. Part of the enforcement effort regarding these rules consists of preparing guides for sellers that describe the rules in everyday terms.²⁴ These direct remedies appear to be effective in discouraging potentially deceptive practices involving RBC price offers.²⁵ Consumer education efforts are also an important approach to help consumers learn to protect themselves from deceptive practices.

Although RBC transactions can be part of deceptive practices that are likely to harm consumers, other RBC transactions (as described below) appear to increase competition. Further, the deceptive uses of RBC price offers often can be remedied more directly with rules that can be enforced with objective analysis and without harm to competition.

3. Effects of RBC laws on retail dynamics

Stringent RBC laws limit loss leader sales by resellers. Hence, an important element in evaluating RBC laws is to identify conditions, if any, in which loss leader sales are likely to promote consumer welfare, competition and efficiency rather than harm them. (The latter are discussed in Parts B through D of the previous section.) Subsection A discusses conditions in which RBC sales can have beneficial effects on consumers and competition. Subsection B examines regulations concerning resale trade more generally, including effects on innovations in retailing techniques. Subsection C describes how weakening of competition at the distribution level in the chain of production may also weaken competition at the manufacturing level.

3.1. Examples of legitimate business justifications for RBC transactions

There are a variety of circumstances in which RBC (loss leader) sales may be a legitimate business practice if they do not violate rules against predatory foreclosure, precipitate inefficient free riding, or involve consumer deception.²⁶ These legitimate business reasons can be cost-effective components of competition that benefit consumers by undermining existing market power,

fostering innovation, and supporting additional choices for consumers. Additional choices can allow consumers to better match their preferences with respect to what they buy, how much they buy and how they buy it. If resellers are prohibited from using cost-effective marketing and sales techniques, they will either have to resort to higher cost, substitute techniques or they will not be able to enter or stay in business. Many of these business justifications for RBC sales focus on conveying information about products or resellers to consumers. Generally, practices that convey truthful information to consumers allow consumers to make better purchasing decisions.²⁷ This will sometimes result in consumers switching between suppliers or products that are partial substitutes. At other times it will reinforce existing purchasing patterns. These are also legitimate business motivations for RBC sales in the sense that they can be part of competition on the merits. That is, if the RBC sales do not improve consumers' views of the product or reseller, they are unlikely to benefit the reseller. These business considerations are also legitimate in the sense that they are widely undertaken by firms that are unlikely to be able to exercise market power as a result of offering unusually low prices.

While individual RBC laws may provide exemptions for some legitimate business practices, doing so complicates enforcement and raises administrative costs. Enforcement becomes more complicated because enforcement agencies must evaluate each suspect behaviour or its justification to determine if it falls under one of the exemptions. Rarely do business practices remain static for an extended period of time. Rather, business practices evolve with changes in consumer awareness and behaviour and with developments in business research. As a result, the task of determining if a new business practice fits a historical list of exemptions is likely to become complex over time even if was initially simple. Enforcement litigation becomes more complex as well because the agency must explain why each challenged practices does not fall under one of the exemptions. Complexities in deciding which cases to bring and in explaining these decisions increase administrative costs. Complexities also afford defendants additional precedents and opportunities to try to convince regulators or courts that a practice is related to a recognised exemption even if the practice does not initially appear to qualify.

Complexities also give rise to potential enforcement errors. In this context of RBC law enforcement, a "Type I" error occurs if the agency claims that a practices is not a legitimate business practice when, in fact, it is.²⁸ If the activities of the competition agency are viewed as a form of hypothesis testing about business practices, the null hypothesis for the agency is that the practice is legitimate. A "Type II" enforcement error occurs if the agency finds that a practice is a form of legitimate competition when, in fact, it is not.

The potential for errors in administering RBC laws creates regulatory risk and compliance costs for resellers. In order to avoid regulatory risk, firms may

undertake practices or investments that consume resources and reduce the vigour of competition. Complying with complex regulations may involve costs such as educating managers and other employees, maintaining detailed records that would not otherwise be done and developing internal compliance monitoring systems. All of these may consume resources and increase prices paid by consumers.

The following paragraphs contain sketches of individual business concerns that are likely to be legitimate and that may cause a firm to violate RBC laws. These are legitimate business concerns from the various perspectives discussed earlier in this section. The listing is intended to be illustrative rather than exhaustive.

Product Trial: Consumer inertia is a commonly observed characteristic of markets for differentiated products. Consumers are often used to buying the same products and they tend to continue to do so even if substitute products are available that they might prefer if they knew more about them. Satisfaction with the current product and bad experience in the past with substitute products can be difficult to overcome for a new entrant or an established product that has been improved.

Typically, an essential step in getting a customer to switch products is to get them to try the new or improved substitute product.²⁹ This pertains especially to differentiated experience goods.³⁰ It is a legitimate business concern for either manufacturers or resellers to obtain customer trial for new or improved products. Indeed, it may be essential in bringing product innovations to market. “An innovation is a product so new and unique that buyers find the concept somewhat foreign. It does not yet have a place in buyers’ lifestyles or business practices. Consequently, the market requires substantial education before buyers recognise the product’s benefits and accept it as a legitimate way to satisfy their needs... Consequently, before a product can become a success, its market must be developed through the difficult process of buyer education.”³¹

One way to obtain customer trial of a new product is to “pay” customers to educate themselves. However, paying customers directly can be administratively costly or impracticable. One potential alternative is to offer a reduced price for the new product. This can be interpreted as two transactions. The first is the traditional purchase of a product by consumers at the normal price. The second is a payment by the seller to consumers to induce them to try the substitute product. It is noteworthy that in this scenario, a net RBC transaction results not from a low price for the traditional product purchase, but from the high “price” that consumers “charge” to induce them to try the product. Ironically, when differentiated existing products are well entrenched or the new product is unique, suppliers of new or improved products are more

likely to have to violate RBC laws in order to induce consumer trial. Further, the potential difficulties of buyer education do not necessarily disappear quickly, if ever. For example, when use of a product spreads slowly, a product is infrequently purchased by some consumers or consumers do not educate each other about the product, manufacturers and resellers may face an extended period in which they have incentives to educate consumers by offering low prices to get them to try the product.

By blocking low prices that induce consumer trial, RBC laws could slow product innovation and discourage consumers from realising the benefits of new products. Other techniques to induce consumer trial may be less effective and more costly.

Outlet Trial: Consumer inertia is common with respect to outlets (stores), as well as to products. Consumers are often used to buying from the same store(s) and they continue to do so even if a substitute outlet would better fit their preferences. Again, inducing consumers to try a different outlet is a legitimate business concern for new or improved outlets and may be essential for successful entry (even of more efficient entrants). Again, offering a direct payment for shopping in a different location may be administratively difficult or costly. Offering an unusually low price may be the most attractive means to induce trial. When existing suppliers (outlets) are well entrenched, the new or improved reseller is more likely to have to violate RBC laws in order to induce trial. Consequently, RBC laws can impede entry of new resellers.

More generally, in the presence of imperfect competition and imperfect consumer information, loss leading in multiproduct retailing can result in the most efficient outcome available. Walsh and Whelan's conclusion from modelling loss leader sales in this context is of interest:³²

Antitrust policies should only target retailing practices that reduce social welfare. Price constraints in multiproduct retailing tend to be implemented on the basis that loss leading involving below-cost selling is predatory in effect and reduces long-run welfare. In this paper we formally model multiproduct retail pricing in imperfectly competitive markets with full consumer information. This creates long-run endogenous price divergences, or the ability to sustain prices above marginal cost. Hence, under conditions of *laissez faire* retailing and imperfect competition between retailers, the welfare outcomes that are generated are second best. Predatory options, in the guise of loss leading, materialise when we assume the presence of imperfect consumer information. However, these predatory options are shown not to be predatory in effect. Strategic responses from rival retailers ensure that the market is self-correcting. Long-run welfare and equilibrium concentration outcomes remain equivalent to *laissez faire* full consumer information levels. Thus, price controls are not justified as

a means of improving welfare to laissez faire full-information levels. The use of price constraints as a second-best policy instrument actually creates distortions that reduce welfare to a third-best outcome.

A blanket prohibition of below-cost pricing in multiproduct retailing that is motivated by the Areeda-Turner pricing rule is clearly undesirable in imperfectly competitive markets with imperfect information. Price intervention imposes a distortion on the market that adversely alters long-term structure and welfare. One should not use price controls unless one understands how this instrument will interact with the imperfections of the second-best world.

New resale formats: At a broad level, competition between resellers may involve innovations by a whole new category of resellers offering a different format. The spread of new retail formats may be a particularly important form of competition related to Joseph Schumpeter's conclusion that "major" advances in efficiency typically do not originate within an existing competitive structure, but are instead a consequence of the entry of competitors with fundamentally different products and/or more efficient processes, which result in radical changes in the competitive environment ["the gale of creative destruction"]. Applied to distribution, Schumpeter's theory suggests that major improvement in distribution efficiency will be associated primarily with the emergence of new methods of distribution, and not from competition for market share among existing competitors operating with a given distribution technology.³³ As in the case of Outlet Trial, a key challenge for resellers providing a new retail format is getting consumers to try, accept and come to value the characteristics of that format. The challenge of gaining consumer trial and acceptance is bigger when the innovative format is markedly different from conventional resellers. Again, when existing suppliers (with the conventional format) are well entrenched, resellers with a new format are more likely to have to violate RBC laws in order to gain consumer trial, acceptance and loyalty.³⁴ If so, stringent RBC laws could regard the pace of innovation and increased efficiency in distribution.

Overcoming switching costs: "The greater the product-specific investment that a buyer must make to switch suppliers, the less price sensitive that buyer is when choosing between alternatives."³⁵ If a customer is already using another product and the switching costs are substantial, it may be entirely rational for the customer to continue with the incumbent supplier even if a competing product is better and less expensive. One way that the producer or reseller of the superior product can expand in the market is to offer to compensate customers for their switching costs. One way to do that is to offer a low price for the first set of purchase or reduced prices for an extended period of time. Free or even negative prices may be necessary if customers' switching costs are large. RBC laws may make it very difficult for innovative

manufacturers or resellers to dislodge incumbent suppliers if customers' switching costs are high.

Racing down the learning or experience curve: Average costs of some products have been found to be a declining function of a firm's cumulative output. This is called an experience curve. Firms in an industry characterised by an experience curve have incentives to accumulate volume faster than other firms because doing so lowers their costs relative to competitors and should increase their profits in later time periods.³⁶ Economic efficiency in this circumstance is enhanced by a rapid growth in accumulated volume because this lowers consumption of resources needed to produce a unit of the product. Manufacturers and associated resellers will have an incentives to price below cost during the early stages of the market in order to accumulate volume and, thereby to attain lower average costs sooner. Stringent RBC laws could prevent resellers from contributing to a manufacturer's race down the experience curve. Resellers may have incentives to assist a manufacturer's race down the experience curve if, for example, they have a long-term supply agreement with the manufacturer or a profit sharing arrangement with the manufacturer. If RBC laws prevent resellers from assisting manufacturers in this way, these rules could impede productivity improvements and delay lower costs that support lower prices.³⁷

*Loyalty rewards that substitute for other costs:*³⁸ For established resellers or entrants seeking to expand sales and become established suppliers, retaining existing customers is a constant challenge and a legitimate business concern. Resellers sometimes try to do this by engaging in extensive advertising activities that can create consumer awareness and a favourable impression of the reseller. However, extensive advertising activity can be costly. Some suppliers may find that it is more cost-effective to offer lower prices to repeat customers (loyalty discounts) than it is continue to incur high advertising expenses.³⁹ The loyalty discounts reflect the lower costs of serving loyal customers.⁴⁰ Alternatively, offering loyalty discounts can be a less costly way of retaining customers than the alternative of high levels of advertising.

The issue that arises when resellers seek to use loyalty discounts in the presence of RBC laws is that these offers may be more effective if the discounts are concentrated on a few products rather than spread across all products. For example, it may be more noticeable or memorable to loyal customers to receive 20% off on milk, eggs or gasoline than to receive 1% off on a wide variety of products. Concentrating loyalty discounts on a few items is, however, more likely to result in violations of stringent RBC laws than spreading the loyalty discounts. In this case, the RBC laws force the reseller to use a less efficient form of loyalty discount and this may cause the supplier to revert back to extensive advertising that consumes real resources.

Intensity of use pricing and other forms of price discrimination: Many personal and business equipment items such as cameras, copy machines, and printers share the characteristic that intensity of use varies a great deal between customers. Manufacturers could try to recover all their variable and fixed costs by charging a price with a high equipment price, but this means that many potential consumers who would be willing to pay more than the short-term marginal costs, but less than average costs, will not be able to afford the equipment. It also means that high use customers are paying much less than they would be willing to pay for the product.

In response to these differences in demand among customers, other manufacturers and retailers may adopt a different strategy involving a low price for the equipment combined with higher-than-normal prices for inputs used by the equipment such as film, ink or paper that are designed specifically for use with that machine. This is a form of price discrimination, the practice of obtaining higher profit margins from customers who are less price sensitive.⁴¹ An intensity-of-use pricing strategy results in higher total prices for customers who use the equipment more intensively and lower total prices for customers who rarely use the equipment, although the per use price may be similar.

In order to attract low-use customers, a reseller could even decide to give away the equipment for free and generate all of its revenue from the sale of machine-specific film, ink and paper, for example. Customers with low volume use are likely to benefit from this marketing strategy. RBC laws could eliminate this potential marketing strategy on the basis that equipment prices do not cover costs. The fundamental problem with enforcement of the RBC laws in this scenario is that the materials are necessary in order to actually use the machine. Hence, the price relevant to consumers is a combination of the equipment price and the price of the materials. But if the combined price is the price that should be measured, enforcement of the RBC laws becomes impracticable because the actual price is not determined at the time the equipment is purchased. The combined price depends on the future behaviour of the customer as well as on the future prices of the machine-specific inputs. Another perspective on this price strategy is to evaluate it in terms of risk. The high equipment price strategy puts much of the risk on consumers. If consumers buy the equipment and then do not like it or find something better, they have spent a lot but received little benefit. Conversely, the low equipment price strategy puts much of the risk on the sellers. If consumers do not like the equipment, they have lost little. From a risk perspective, the low-price equipment strategy appears to provide benefits for consumers, particularly in the case of novel products.

Note that in some markets, price discrimination may be necessary for any supply to be forthcoming. This occurs if the single monopoly price yields

revenue that is less than total costs, but price discrimination yields sufficient revenue to cover total costs. A parallel situation could arise in reselling if the manufacturer's price is high enough that price discrimination in reselling is necessary to cover resellers' costs. In this case, RBC laws could prevent any distribution of the product in a jurisdiction because the laws would prevent the necessary resale price discrimination.

Price discrimination more generally may be beneficial, harmful or neutral with respect to consumer welfare. Price discrimination arises because consumers evaluate products and services differently under conditions in which suppliers can separate customers on this basis, can charge different prices and can avoid substantial arbitrage from low-price customers to high-price customers.⁴² In conditions in which price discrimination is likely to be welfare enhancing,⁴³ RBC laws may prevent these beneficial welfare effects (and the reverse). In a typical price discrimination scenario, rather than offering a product at a single price, the seller finds it profitable to offer lower prices to the more price sensitive customers and higher prices to the less price sensitive customers. The firm is presumably more profitable as a result of price discrimination, so its prices are above costs. However, the profit maximising combination of prices might very well involve charging a price above average costs to one group of customers and a price below average costs to the other group of customers. RBC laws, if applied to manufacturers, could make the latter illegal. In the case of a reseller, the lower price offer likely would be greater than marginal costs (which might be the acquisition costs). If RBC laws do not allow the reseller to take into account off-invoice price allowances, the RBC laws could prevent the reseller from charging the preferred price to the price-sensitive customers, namely a price greater than the actual acquisition price, but less than the invoice price. The price-sensitive consumers would be harmed by this application of RBC laws.

Unspecified store-wide discounts: If a reseller offers a wide variety of products and there is little overlap in the sets of products that customers buy, the merchant may not be able to attract a sufficient number of customers with discounts on a specified subset of products. For example, a book seller could be in this circumstance aside from "best sellers". One alternative is to offer a general discount on any one or more items that a customer decides to buy. Such an offer is easy to understand and gives each customer confidence that the offer will actually result in savings. Problem arise in making this type of offer, if the reseller is already offering some items at thin markups over costs and RBC laws are in place. When the discount is applied to the items with thin markups, the transaction prices can fall below costs. This scenario presents two quandaries. First, in order to avoid this scenario, the reseller could: raise markups on low mark-up items before making the discount offer, specify items to which the discount does not apply, specify the items to which the

discount does apply or reduce the level of the discount. Each of these alternatives has drawbacks, including raising prices above the preferred level for some period of time, increased marketing costs or reduced consumer response to the discount offer. The second quandary is that enforcement officials may find it difficult to prosecute the reseller because it is the consumer's choice that determines if an item with a low initial mark-up is sold at an RBC price.

Information clutter – Discontinuities in consumer responses to lower prices: A key marketing concern for a reseller is clutter from marketing claims made by rivals or by resellers of unrelated products.⁴⁴ Consumers have limited ability and interest in marketing claims. As a result of clutter, claims that are exceptional are more likely to receive a substantial consumer response, while conventional claims may go almost unnoticed.⁴⁵ If conventional price reductions have little or no effect on volume, they are unlikely to be profitable and may be discontinued. Large price reductions that offer RBC prices, may still be profitable in the aggregate if they result in large increases in store traffic with associated purchases of regularly priced items. This practice of loss leader sales is common where RBC laws are not in place. The contrast shows that RBC laws prevent resellers from using the most efficient marketing tools. As a result, resellers may employ more costly marketing tools and some of these, such as advertising, may consume real resources. To the extent that competition between resellers is dampened, consumers may be harmed. Further, resellers that are less pressured by competition to reduce prices may be less aggressive in seeking price concessions from manufacturers (see Section C below).⁴⁶

Inducements to apply for credit from a reseller: Resellers may find it profitable to offer credit to consumers if their costs of offering credit are less than the fees charged to the reseller when a customer uses a third party credit card. However, consumers may regard the application process and the additional billing statements to be unattractive. One way to induce consumers to apply for a credit card from the reseller is to offer a discount on one or more purchases made with the reseller's credit card. Effectively, the discount compensates customers for the time and effort to apply for the reseller's credit card. This is akin to a switching cost. As in the situation of generalised storewide discounts, the selection by the consumer of a low-margin item on which they take the discount may result in RBC transactions.

Inducements to provide customer feedback: Resellers may also want consumer feedback on customer service, hours, personnel, product selection, etc. Obtaining feedback may be difficult because it requires time and attention from customers. One way to encourage feedback is to offer something to customers who decide to provide the feedback. One type of offer is a discount on one or more purchases from the reseller. The same issue about potential sales below cost arises in this circumstance as in the scenario of store-wide discounts and inducements to apply for credit from the reseller.

Resellers with two-part tariffs: Resellers with particularly thin markups are more likely to have RBC transactions when they offer store-wide discounts or discounts that are not product specific. Resellers with two-part tariffs may be particularly prone to RBC transactions if the initial access tariff is not taken into consideration. Generally, resellers with two-part tariffs can take very low margins on many products and rely on the membership fees and very high volume to be profitable. Sam's Club and Costco are examples of resellers using a two part tariff strategy in the US.

Manufacturer participation in "specialing": Because demand at the manufacturing level for consumer goods is derived from retail sales, manufacturers of well-known search and experience goods with established quality reputations are often eager to reduce the margins of resellers. Loss leader sales offer manufacturers something even better for their perspective – negative reseller margins. One way that manufacturers may compete with each other is to offer lower prices to resellers who are using the manufacturer's product as a loss leader. This form of competition at the manufacturing level makes loss leader offers more attractive to resellers. For the same negative margin, they can offer an even more noticeable price reduction to consumers and may gain disproportionately more profits from increased store traffic and associated sales of products with positive margins. Consumers benefit directly from the lower prices on loss leaders. The consumer savings from buying the loss leader may or may not be offset by purchases of other products at this outlet at normal markups. The net savings for a consumer depend on the volume of loss leader and non-loss leader items purchased and the prices on both types of products at the retailer with the loss leader policy (compared to other retailers that the consumer would otherwise have patronised). In the presence of RBC laws, loss leader reselling will be absent among resellers and manufacturers of products that make good loss leaders⁴⁷ may be less inclined to compete by offering reduced prices to resellers. Resellers then would have fewer savings from manufacturers' discounts to pass on to consumers in this situation.

Accounting conventions: There are a variety of accounting conventions that deal with resellers' inventories. Standard accounting treatments include average cost, last-in-first-out and first-in-first-out.⁴⁸ These accounting treatments of inventories result in different accounting costs for goods taken from inventory at any specific time if additions to inventory vary in cost. As a result, the same resale price could be above, below or the same as the resale cost depending on which accounting convention a reseller uses. Two competing firms that charge the same resale price and have the same history of purchases and withdrawals could be judged differently with respect to violating the RBC law if they chose different accounting conventions and the violations are established using each firm's accounting convention. If violations

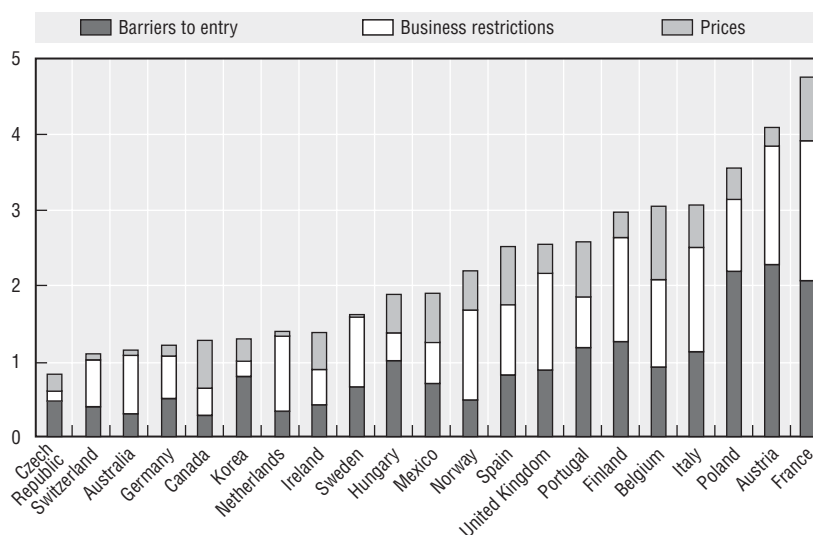
are established using a specific accounting convention, then a firm could be convicted when its own accounts show that it was in compliance with RBC laws. Reliance on one convention over another by enforcement agencies could create incentives for resellers to adopt an accounting convention that is less efficient for business operations or that would require considerable switching costs to initiate.

3.2. Retail regulation and retail dynamics

RBC laws are one of a set of regulations applied to the retail distribution sector, despite its generally competitive nature fostered by many suppliers and entry that generally can be timely and with limited unrecoverable sunk costs. Large unrecoverable costs would make entry less likely. Reselling does not usually involve large quantities of industry-specific equipment, rather, the chief investment is often structures that can be used for other purposes and inventories of goods that can be also be sold to other resellers if an individual outlet leaves the business. Of the many sectors that have been subject to pricing regulation, retailing is one the least likely to be subject to natural monopoly or public good elements. These concerns are the typical economic justifications for intensive government involvement in an industry, public utilities for example.

OECD economists have organised information on regulations applied to retail distributors into categories consisting of market access, business operation and pricing regulations.⁴⁹ The first includes business registration and start up requirements, locational restrictions, limits on products/services offered and impediment to establishment of large stores. The second includes regulation of hours of operation and promotional activities, local monopoly franchises and the involvement of industry associations. The third includes RBC laws and some direct price controls. Looking across retail regulation types, France was found to have the most restrictive regulatory stance in the retail sector, including the pricing component. Figure 2 from Olivier Boylaud and Giuseppe Nicoletti, “Regulatory Reform in Retail Distribution”, OECD Economic Studies No. 32 (2001) is reproduced below.

Researchers have also examined relationships between intensity of retail regulations and various measures of economic performance using either simulations or econometric techniques. Summarising nine such studies conducted in the 1990s, OECD staff concluded “over-regulation can damage consumers’ purchasing power and impede the modernisation of the sector” and “the available empirical evidence suggests that restricting access by imposing special requirements for outlet registration, siting and/or size of thresholds curb the dynamism of the industry (e.g., lowering entry and exit rates, and preventing restructuring and modernisation) and competitive pressures, leading to lower employment growth and higher consumer prices”.⁵⁰

Figure 2. **Summary indicators of regulation**¹

1. The scale of indicators is 0-6 from least to most restrictive.

In addition to the long-familiar competition between department stores or between bakeries, but another important type of competition in the retail sector occurs between traditional resellers and new resellers taking a different approach or using a different technology. Historically there have been repeated cycles of innovation in the retail sector including department stores, retailers with affiliated catalogue operations selling to rural customers, supermarkets, category killers (Toys “R” Us, for example), mass merchants and now Internet-based retailers.

Sometimes retail innovations focus on a demand niche that differs from conventional reselling. For example, a retailer may specialise in clothes for tall men or items that travellers may want. Such specialty retailers may offer customers a better selection of a narrow line of products than generalised retailers, and may offer personalised assistance not needed by customers of less specialised products or services. Specialty stores are likely to have higher service costs than generalised retailers because of the extra services they provide. But specialty retailers may be able to obtain lower prices from manufacturers because they procure unusually large quantities of specialised merchandise and provide scale economies in manufacturing, marketing and distribution to manufacturers (and wholesalers).

Another type of retail innovation is offering only well-known products for which consumers need little help in making informed purchase decisions. Retailers that focus on selling well-known brands (mass merchandisers) are

likely to have lower service costs than generalised retailers, as well as being able to obtain lower prices from manufacturers. Manufacturers may offer lower prices because of the scale economies of transactions with mass merchandisers or because mass merchandisers perform some functions that the manufacturer would otherwise have to provide. Mass merchandisers often compete by offering lower prices than generalised or specialty stores because they have lower procurement and service costs and because they rely more heavily on consumer self-service.

In contrast to specialty stores or mass merchandisers, today's traditional resellers, such as department stores, may emphasise "one-stop shopping" with a wide variety of products and an intermediate level of service sufficient for most consumers or full-service for selected items where most consumers want such assistance.⁵¹ Consumers may be attracted to this model because it is convenient and saves time.

Which approach to reselling will be the most commercially successful and which will persist, even if others predominate, is up to consumers in a market economy. The answer may change over time and across geographic space as consumer preferences, incomes and demographics change. Historically, traditional retailers have not been content to compete solely on the basis of efficiencies and marketing expertise. Instead, they have resorted, from time to time, to other techniques to prevent or slow innovations in reselling at the wholesale and retail levels. Techniques of this type have included unilateral or coordinated pressure on manufacturers not to sell to specific types of resellers; pressure on manufacturers not to offer discounts to innovative forms of reselling and legal restrictions on marketing and pricing techniques that are used predominantly by innovative resellers. Former FTC staff economist Robert Steiner has written extensively on competition between different approaches to retailing and the costs to consumers of some of the efforts by traditional resellers to stifle innovations in retailing.⁵²

Analysis of US productivity data from the 1990s adds weight to the importance of competition between different types of resellers. The McKinsey consulting firm concluded:⁵³

Who would have expected the retail sector to be a big part of the new-economy story in the United States? Retailers seemed to have been left out of the technological and operational improvements that transformed US manufacturing. Yet retail-labor productivity growth more than tripled after 1995, contributing roughly one-quarter of the national productivity acceleration of 1995-99. The reason can be explained in just two syllables: Wal-Mart, whose operational innovations – including the "big-box" format, "everyday low prices," electronic data interchange with suppliers, and economies of scale in warehouses – forced competitors to adapt.

Wal-Mart's innovations, both large and small, are now retail-industry standards. Yet Wal-Mart still has a sizable productivity edge over its competitors and continues to raise the bar. The result should be more productivity growth in the retail sector in the five years to come.

There are three important elements from the discussion above that relate to potential fairness issues and inefficiencies associated with stringent RBC laws. First, RBC laws are more likely to be binding on mass merchandisers than on traditional or specialty resellers. Hence, there is a question of horizontal fairness in enforcing RBC laws. Second, RBC laws may constitute a form of cheap exclusion by raising rivals' costs when RBC laws are selectively binding on mass merchandisers. Third, RBC laws may distort resellers' decisions about vertical integration if RBC laws or substitute laws are difficult to apply to the internal transfer pricing policies or long-term supply contracts of more vertically integrated resellers.

Horizontal fairness: Traditional or specialty resellers generally charge prices that have a higher margin over product acquisition costs than mass merchandisers. As a result, an equal percentage discount by a traditional or specialty reseller and a mass merchandiser is more likely to result in a violation of RBC laws by the mass merchandiser. To see this, consider two resellers. Firm A is a specialty toy store and Firm B is a mass merchandiser that also sells toys. Assume that both are initially selling toys at 10% above total average costs and both have the same acquisition costs for toys. The difference between the firms is that the specialty store has a 20% mark-up to cover its higher customer service costs while the mass merchandiser has a 5% mark up to cover customer service costs. Both firms can coexist because some consumers prefer the extra service or prestige associated with buying from the specialty store, while some are content with the lower level of service at the mass merchandiser because prices are lower. In preparation for the Christmas season, both firms are considering offering discounts on the same highly popular toys. Both stores realise that the discount has to be at least 20% for customers to notice and respond to the discount. The specialty toy store has no legal problem in offering a 20% discount, even though this price is below its average total costs (including service costs). However, the mass merchandiser will violate RBC laws if it offers a 20% discount off its regular prices because the 20% discount is greater than its regular margin above acquisition costs. In this scenario, the mass merchandiser is unable to offer an attractive discount during the Christmas season on the highly popular toys. A resale-below-total-cost standard would provide horizontal fairness in this scenario, but a RBC standard based on product acquisition costs does not provide horizontal fairness.

Raising rivals' costs: Absent the ability to legally offer compelling discounts, mass merchandiser may have to turn to other approaches to attract customers.

These may include increased advertising or other marketing approaches. But these alternatives may be less profitable and may consume valuable resources. If offering retail discounts of at least 20% is sufficiently critical to commercial viability, the mass merchandising approach may never develop in an area with stringent RBC laws or may be forced to exit. Consumers who prefer this retailing format will be forced to pay higher prices for products and to consume (or endure) retailer services that they do not need or want at other types of retailers.

Distortions in vertical integration (make versus buy) Decisions: Firms generally face a wide variety of “make versus buy” decisions.⁵⁴ Should a women’s clothing retailer design and manufacture the dresses it sells or buy them from fashion designer and manufacturer? Should the office supply store offer only its own brand of paper or should it also sell other brands that it buys from independent paper manufacturers. In economic terms: how vertically integrated should the firm be?

In a competitive setting, firms decide whether to vertically integrate or buy from independent suppliers by comparing the expected profitability of the alternatives and by considering the associated risks. RBC laws can distort decisions about vertical integration by penalising firms that are not vertically integrated. In particular, a firm that is vertically integrated does not engage in reselling even if the products it offers to consumers are close substitutes to the products offered by resellers.⁵⁵ A firm that is vertically integrated can offer prices associated with the various legitimate business concerns (discussed above) that may violate RBC laws if undertaken by a reseller.

3.3. Intensive competition between resellers can carryover to competition between manufacturers

When a reseller faces intense competition, it has strong incentives to press its suppliers for lower prices, cost-saving innovations and new products that will attract consumers. The mass merchandisers are well known for encouraging efficiencies at the manufacturing level. Wal-Mart, for example, works toward long-term supply agreements that allow manufacturers to invest in equipment and techniques that lower their production costs.⁵⁶ Unless it does so, it will be forced out of business and its owners will face the loss of unrecoverable costs. Conversely, when a reseller faces less intense competition, its owners may take some of the higher available retail margins in the form of lax efforts to gain pricing concessions, cost savings and new products from suppliers. In this context, resellers are like retail consumers in the sense that their search behaviour and buying decisions vary with their tastes, income and wealth. If resellers engage in less intensive search for low prices and less intensive bargaining with manufacturers because they are insulated from competition, more efficient and more innovative manufacturers

(and wholesalers) are likely to grow less rapidly and they are less likely to be able to displace less efficient and less innovative manufacturers. Consumers will experience higher prices and reduced innovation as a result.

4. RBC laws, regulatory climate and economic growth

In addition to the specific microeconomic effects of RBC laws on the behaviour of existing resellers and on the entry of resellers, economic research suggests that there are links from a restrictive regulatory climate in a nation to slow economic growth rates and elevated unemployment levels. High levels of regulation potentially stifle innovation, entry and entrepreneurship.⁵⁷ Regulations such as RBC laws that create regulatory risk concerning marketing approaches that facilitate consumers gaining experience and information about new products and new resellers are particularly problematic.

Two recent OECD country reports underscore the importance of regulatory climate in promoting economic growth and low unemployment. These reports concern New Zealand and France.⁵⁸ The former finds that New Zealand has significantly increased its economic performance over the past 15 years by substantially reducing the role of regulation and government ownership in the economy. Retail trade is one of the sectors specifically mentioned for thriving competition. Healthy competition, promoted by earlier regulatory reforms, encourages firms to innovate and become more efficient. New Zealand now enjoys an expanding economy with low unemployment. In contrast, the latter finds that France has experienced relatively slow economic growth and high levels of unemployment (approximately 10%) over much of the same period under a relatively restrictive regulatory climate. The report singles out “absence of competition in parts of retailing” (under the *loi Galland*) as a factor that reduces “the potential for growth, innovation, and employment”. It adds, “in the retail sector extra layers have been added (to laws against predatory pricing) which impose detailed price-related regulation on some areas, preventing consumers from reaping the full benefits of competition among producers and adding to annual inflation”.

A report on the McKinsey Global Institute’s studies of productivity growth in the 1990s observes:⁵⁹

It’s as much about competition policy that discourages retail innovation as about technology policy...In Europe, anticompetitive retail policies are common, restricting real estate use, store hours and what can be sold by whom. Wal-Mart [which is responsible for more than half of US productivity gains in the retail sector during the 1990s] developed in a largely unregulated environment, so its big-box model can’t be copied in much of Europe... If anything, the restrictions on retail in other parts of the world may hurt standards of living more than they hurt productivity... because you can

still have a very productive store if it's only open five days a week... [Studying productivity] reinforces the view of how important the basics of competition and capitalism are to improving productivity. It gives you a sense of don't hope for silver bullets – let the market work.

Much of the leading research comparing the regulatory environments in several nations to differences in economic growth and unemployment rates has taken place at the OECD.⁶⁰ A critical element in this research is the OECD's International Regulation Database. This database includes information on a wide range of regulations based in large part on survey responses regarding the existence and type of regulation applied in each country. It also incorporates information from other sources. The data has been reviewed by government and OECD experts. The regulations included in the database can restrict firms' decisions over entry, exit, the use of inputs, the quantity and type of output produced and prices.⁶¹ They can include both economy-wide and industry-specific regulations. The database also contains information on market and industry structure for industries that have been heavily regulated in the past. Product market regulations are distinguished from labour market regulations in the database. There are several limitations of the data base including lack of information on informal types of government regulation, quality of regulatory decisions or enforcement and private restrictions that may substitute for government regulation. Among the relevant database findings is that nations with tight entry regulations also tend to impose burdensome administrative procedures on enterprises.

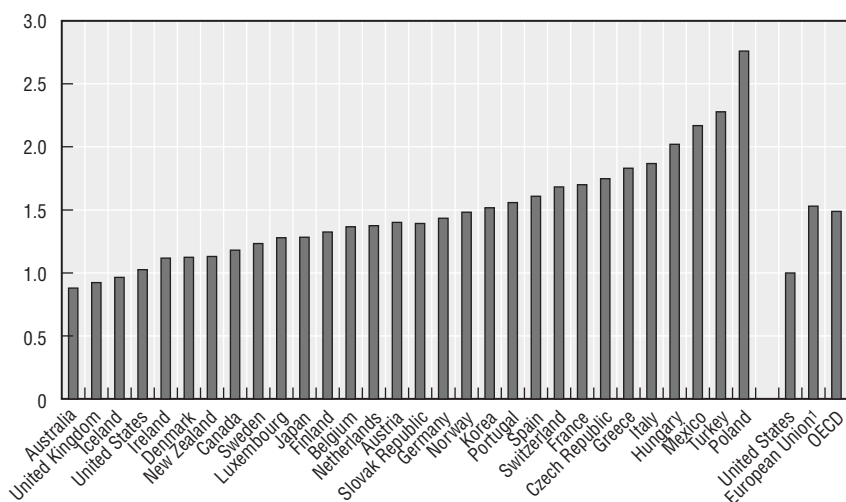
A World Bank research paper summarises the relationships found between regulatory climate and economic growth through the end of the previous millennium.⁶²

In this paper, we look at differences in the scope and depth of pro-competitive regulatory reforms and privatisation policies as a possible source of cross-country dispersion in growth outcomes. The paper suggests that, despite extensive liberalisation and privatisation in the OECD area, the cross-country variation of regulatory settings has increased in recent years, lining up with the increasing dispersion in growth. We then investigate empirically the regulation-growth linkage using data that cover a large set of manufacturing and service industries in OECD countries over the past two decades and focusing on multifactor productivity (MFP), which plays a crucial role in GDP growth and accounts for a significant share of its cross-country variance. Regressing MFP on both economy-wide indicators of regulation and privatisation and industry-level indicators of entry liberalisation, we find evidence that reforms promoting private governance and competition (where these are viable) tend to boost productivity. In manufacturing the gains to be expected from lower entry barriers are greater the further a given country

is from the technology leader. Thus, regulation limiting entry may hinder the adoption of existing technologies, possibly by reducing competitive pressures, technology spillovers, or the entry of new high-tech firms. At the same time, both privatisation and entry liberalisation are estimated to have a positive impact on productivity in all sectors. These results offer an interpretation to the observed recent differences in growth patterns across OECD countries, in particular between large Continental European economies and the United States. Strict product market regulations – and lack of regulatory reforms – are likely to underlie the relatively poorer productivity performance of some European countries, especially in those industries where Europe has accumulated a technology gap... These results also offer useful insights for non-OECD countries. In particular, they point to the potential benefits of regulatory reforms and privatisation, especially in those countries with large technology gaps and strict regulatory settings that curb incentives to adopt new technologies.

A variety of other OECD studies support these conclusions. For example, a more recent OECD research paper on regulation and growth focuses attention on the links between regulatory climate and innovation. It finds that gains in innovation from relaxing regulations may be particularly important for industries near the technology frontier.⁶³ Another link between regulation and economic growth occurs through investment. Economists have examined the relationship between product market regulation, entry restrictions in particular and investment among OECD countries. They conclude that “there is considerable evidence that tight regulation of the product markets has had a large negative effect on investment, a key engine for growth. The data for sectors that have experienced significant changes in the regulatory environment suggest that deregulation is associated in the long run with greater investment. The component of reforms that plays the most important role is entry liberalisation...”⁶⁴ The 2003 update of the OECD’s regulation data base⁶⁵ continues to show that regulations are more constraining in the EU than in the US.

Econometric modelling using the OECD International Regulation Database with economic performance data indicate that moving to less restrictive regulatory practices could benefit all countries, but would be particularly advantageous for those with the most restrictive practices at present. Work with earlier editions of the OECD regulation database provides supportive conclusions. When product market regulatory restrictions are statistically compared to non-agricultural business sector employment rates, the correlation is negative and statistically significant. A correlation of -0.61 was reported for 1995 with a t-statistic of -3.40 .⁶⁶

Figure 3. **Product market regulation indicators in the OECD, 2003¹**

1. The indicators range from 0 (least restrictive) to 6 (most restrictive). EU 15 (simple average)

Source: OECD Economics Department Working Paper 432 (26-May-2005).

Table 1. **Impact of inward-oriented product market reforms on MFP levels and GDP per capita**

% changes

	Effects of reducing state control [1]	Effects of easing entry barriers [2]	Combined impact on MFP levels [1] + [2]	Impact on output ¹
Austria	2.3	0.3	2.6	3.8
Belgium	2.0	0.2	2.2	3.1
Denmark	1.4	0.3	1.7	2.4
Finland	1.9	0.3	2.2	3.2
France	2.4	0.2	2.6	3.7
Germany	1.9	0.3	2.2	3.1
Greece	2.2	0.3	2.5	3.6
Italy	2.2	0.3	2.5	3.5
Netherlands	1.7	0.3	2.0	2.8
Portugal	1.3	0.3	1.6	2.3
Spain	1.5	0.3	1.8	2.5
Sweden	1.6	0.3	1.9	2.6
United Kingdom	1.0	0.3	1.3	1.9
United States	0.5	0.3	0.8	1.1
EU15	1.8	0.3	2.1	2.9

1. The impact on output is a calculated from an assumed Cobb-Douglas production function. Labour's income share is set at 0.7 and capital increases such that the efficiency-augmented capital-to-labour ratio does not change.

Box 3. A natural experiment regarding price and economic integration effects of “big box” retailing

Economists and psychologists interested in marketing questions often focus their research on geographically isolated communities where variations in advertising levels by local television and radio stations are less likely to be “contaminated” by spill in or spill out from stations in other cities. In this relative isolation, natural experiments can then be conducted by varying the content and frequency of advertising. Islands in the Pacific provide a similar type of geographically isolated setting in which the effects of entry by big box retailers can be observed. Big box retailers generally adopt a low-price/high-volume strategy and have been the apparent targets of RBC laws. The Bank of Hawaii, with branches in Guam offered the following assessment of entry on Guam of big box retailers during the mid 1990s.¹

Big box retailing

Big box retailing arrived full speed on Guam in early 1995 when Guam’s K-Mart, the chain’s largest store thus far, opened. Within weeks of K-Mart’s opening, the prices of some household items dropped 15-20 per cent island-wide. With another big-box retailer, Cost-U-Less, now operating two stores on the island, Guam has been integrated into the US mass retail market.

K-Mart, Cost-U-Less and other big box retailers may have caused problems for smaller local operators, but the lower prices which economies of scale make possible have undoubtedly benefited Guam consumers. Gains in total retail sales as reported in the tax base over the last two years offer clear evidence of an overall healthy retail sector.

Guam’s potential apparently has convinced more retailers to look into this market, and more mass retailers are on their way. A factory outlet mall and a multiple-screen theatre complex are expected to open in the months ahead. With these and the assortment of outlets already in place, some of them catering to upscale consumers including tourists, Guam is developing into a regional retail presence.

The message for retailers is clear: Guam is about to become as competitive as other established retail markets. With competition comes the pressure to be responsive, innovative and efficient, since practically every outfit targets the same mix of tourist and resident consumers. Tourists have already begun to sample goods at K-Mart. How many more entrants the sector can support is yet to be seen. However, it is not too early to suggest that Guam’s retail market is going to be dynamic for some time to come and worth watching.

Box 3. A natural experiment regarding price and economic integration effects of “big box” retailing (cont.)

The Big Island of Hawaii experienced similar results which have now become general knowledge. An introduction to the city of Hilo observes: “Twenty years ago what made Hawaii a frustrating place for both kama aina and mainlanders alike to live was the absence of any kind of mainland-style discount store. Price were [and to some extent still are] artificially high and fixed by those who controlled the flow of certain goods. Hawaiians blindly accepted the erroneous notion that goods were so expensive because of the high cost of shipping. But beginning in the late 1980s, diversity blossomed, and firms like K-Mart, Home Depot, and Costco deflated priced abruptly, and Hawaiians now enjoy a greater variety of goods at lower prices than anytime in the islands’ history.”² The Bank of Hawaii similarly observed effects of big box retailing on Hawaii: “New entrants into the retail market have stimulated a competitive response among local retailers benefiting consumers. Like the new entrants, local retailers are pricing their merchandise more aggressively.”³

Similar but less dramatic price effects have been found in association with entry of Wal-Mart in various mainland US Cities.⁴

1. Bank of Hawaii, “Gaum Economic Report – Developments Since 1995” (September 1997), available at www.boh.com/econ/pacific/gm/gm.pdf.
2. Discovering Hawaii, “Hilo, The Big Island’s Capitol City,” available at www.discoverinhawaii.com/Is_BigIsland/Hilo,%20The%20Big%20Island%20of%20Hawaii.
3. Bank of Hawaii, “Consumer Price Index Offers Good News for Hawaii’s Consumers” (19 February 1999) available at www.boh.com/new/990219.asp.
4. Emek Basker, “Selling a Cheaper Mousetrap: Wal-Mart’s Effect on Retail Prices” (March 2005). University of Missouri Working Paper No. 04-01. Available at <http://ssrn.com/abstract=484903>.

5. Trends and variations in RBC laws

The background note for the OECD predatory foreclosure roundtable identified Ireland, France, and Germany as nations with stringent RBC laws.⁶⁷ Given the previous materials on regulatory climate, France, and to some extent Germany, are nations in which stringent RBC laws are not unexpected. Ireland is something of a surprise because it is generally ranked among the nations with the least restrictive regulatory environment. On closer inspection, it is only the groceries industry in Ireland that is subject to stringent RBC laws. In all three countries, RBC laws were enacted or revised relatively recently. And while proponents of all three measures did mention protection of small retailers from big retailers as part of the rationale for the measures, proponents also couched their proposals as means to prevent exercise of monopsony (buyer) power by resellers (supermarket chains and big box retailers) against manufacturers.⁶⁸ Both France and Ireland are in the process of reviewing their RBC laws. Because the policy debate in Ireland is the most recent, excerpts

from the Irish Competition Authority analysis are presented below, along with brief sketches of RBC developments in France, Germany, the UK, and the US

France: France has been considering less restrictive RBC standards that could allow deeper discounting by resellers.⁶⁹ The 1996 legislative revisions (Loi Galland) forbid selling at a loss, which is defined as a price less than the invoice price plus transportation costs and taxes. The law reportedly was updated in part to protect small resellers from large resellers and small manufacturers from large resellers seeking lower wholesale prices.⁷⁰ Enforcement of RBC laws in France appears to be stringent based on OECD reports.⁷¹

These rules have been expanded in order to control the use of what are termed “margins in arrears” (“marges arrières”). These are devices which have the effect of changing the prices effectively paid from those shown on the invoice at time of delivery. Their proliferation demonstrates the bargaining power of the 5 or 6 largest distributors and retailers of consumer goods. Taking advantage of the suppliers’ need to be present in these outlets, these firms reportedly exact up to 50% of the price through such charges and rely on late payment to suppliers – averaging 66 days after delivery – for their own working capital. The charges are often nominally in exchange for marketing services, but multiple, fictitious, or variable billing leads to doubt that they really represent payment for services rendered. Rather, they appear to be devices for discriminating among customers or for evading – or profiting from – the prohibition against setting retail prices below invoice cost. Public enforcement of these controls on supplier-distributor relationships has been strengthened substantially, in part to compensate for firms’ fear of commercial retribution if they bring suit over mistreatment themselves. DGCCRF now has the power to bring civil actions to have abusive agreements invalidated, to order reimbursement of undue amounts, and to impose fines, which can be substantial – up to €2 million. DGCCRF also intervenes to support private suits about unfair discontinuation of supply relationships. The pricing-transparency rules are enforced by criminal penalties. There are also fines for late payments and criminal penalties for fraudulent market manipulation and disparagement.

It is interesting to note that a large portion of total retail margins in France are reportedly due to end-of-year discounts and other payments from manufacturers that are not accounted for in the RBC laws of 1996. Discounts for services provided by the reseller can only be for substantive services and must include a minimum quantity of purchase.⁷² Hence, the 1996 RBC law sets a retail price floor that can be considerably higher than wholesale transactions prices net of discounts, rebates and allowances. Excessively low prices, although not precisely defined, are also generally forbidden under the 1996 law with the intention of preventing low retail prices compared to costs of

production and distribution.⁷³ It appears that enforcement of this latter element has been less stringent than the former because the 1996 law has coincided with extensive development of store brands that entail vertical integration by mass merchants.⁷⁴ Store brands can involve forms of vertical integration (into manufacturing) or long-term supply contracts in which transfer pricing rather than invoicing is involved. It is difficult to reach reasonable RBC price determinations from transfer prices because firms may (and many economist contend, should) transfer at short-run marginal costs rather than long-term total costs (plus profit) as vertically separated firms do when invoicing. Transferring at marginal cost avoids the potential inefficiency of double marginalisation. Overall, studies suggest that resale prices increased as a result of the 1996 law, with the largest increases being for well-known brands.⁷⁵

Germany: Germany's RBC laws went into effect in 1999. Specifically, the law forbids retailers from setting resale prices below purchase prices for extended periods and allows for private enforcement in the case of a defendant with a dominant position.⁷⁶ A 2004 OECD evaluation of retail regulation in Germany observed:⁷⁷

Retail trade in Germany is traditionally highly regulated compared with many other European countries. For example, opening hours are still more restricted than in many other European countries, and there are restrictions on discounts outside the sales seasons as well as prohibition of below cost pricing...

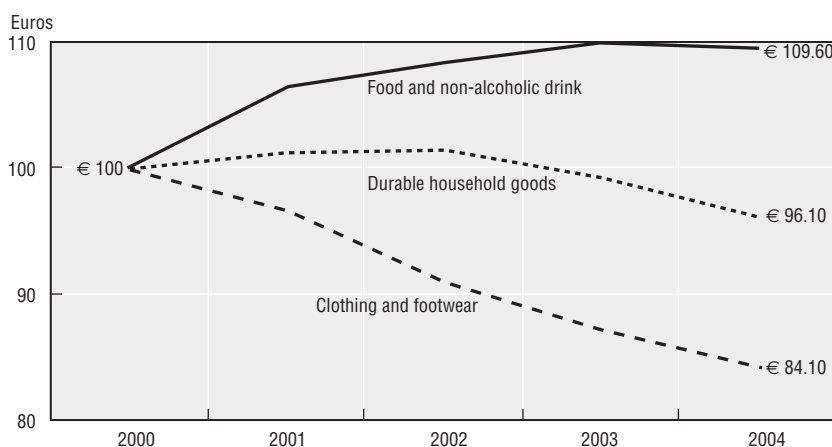
Germany's rules about unfair competition have probably tended to impair competition more than they have promoted it. Some protectionist rules (for example on discounting) are now being eliminated or corrected, encouraged by EU legislation. Two laws that made rebates more difficult were repealed in 2001. Some important protectionist legislation remains, not least the Unfair Competition Act (UCA) which can be used to prevent price competition, and which is still applied in ways that underestimate the extent to which consumers may be able to look out for themselves. A revision of the UCA is underway to reflect EU developments, and to give more weight to the interests of consumers, through Germany is seeking to preserve the rule against sales below cost.

The background paper for the predatory foreclosure roundtable (October 2004) reported on the German Supreme Court case against Wal-Mart for RBC sales of common grocery products such as milk and eggs. The court held that Germany's RBC prohibition applies whether or not there is any harm to competition from the RBC prices and that being a large firm relative to small and medium size competitors is sufficient to show that it has "superior" market power.⁷⁸ Both of these elements in the decision are inconsistent with predatory foreclosure competition laws and instead adopt a harm-to-small-competitors standard.

Ireland: The 1987 Groceries Order arose in part because many believed that large retailers were using below-cost pricing (loss leading) to manage the market, leading to the exit of many medium and small retailers and reducing welfare in the long run due to rising concentration.⁷⁹ The Competition Authority has recently recommended that RBC law regarding the grocery trade be terminated because it is harming consumers. In contrast, the Joint Committee on Enterprise and Small Business recommended keeping the Groceries Order based on concerns about increased concentration in grocery retailing and predatory pricing.⁸⁰ Because the press release from the Irish competition authority presents a strong summary of the argument for abolition, including quantitative evidence, it is excerpted here and included in full in Appendix B.

The Competition Authority concluded that the Groceries order is anticompetitive and costs an average household almost € 500 per year. It first compared price trends in food to price trends in durables and in clothing. This comparison showed price increases for food that were greater for those of durables and that contrasted with price decreases for clothing, as shown in Figure 4.

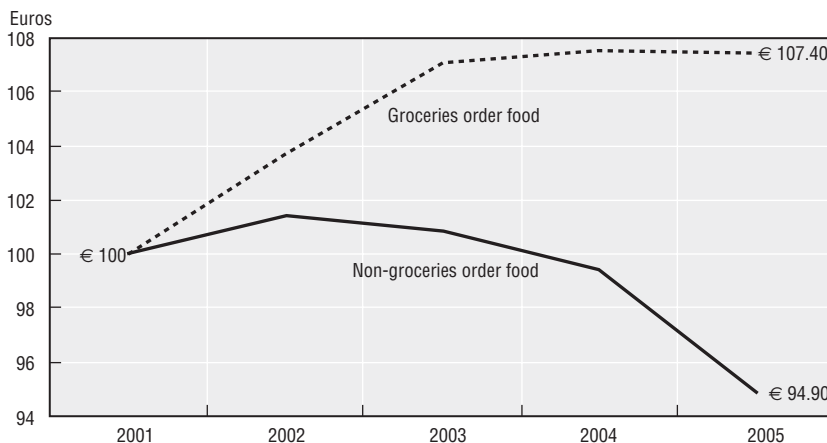
Figure 4. **Irish food prices rise while clothing, footwear and household goods prices fall**



Source: Retail price levels 2000-2004 from CSO data.

The Competition Authority also compared prices trends for foods covered by the grocery order *versus* other foods. The foods covered by the Grocery Order increased in price while other foods decreased in price, as shown in Figure 5. Finally, the Competition Authority found that lower income families are disproportionately harmed by the Groceries Order.⁸¹

Figure 5. **Food covered by Groceries Order rises in price while food not covered falls**



Source: Retail price levels 2000-2004 from CSO data.

The Competition Authority is not the only group to conclude that the Groceries Order has resulted in higher prices for consumers. A 1997 study reached the same general conclusion finding about a 5% increase in grocery store price/cost margins as a result of the 1987 Groceries Order.⁸² An important element in this history is the substitution of RBC laws for RPM, which was discontinued in 1956.

United Kingdom: The Office of Fair Trade (OFT) has been evaluating recent changes in regulation of grocery prices in the UK⁸³ Among these changes was removal of RBC regulations in favour of a less restrictive reasonableness standard. OFT concludes that the reforms have generally proven beneficial to consumers with lower prices, more choices and no decline in quality. The agency also concludes that a return to a more prescriptive set of rules for grocery trading “might well damage the efficient operation of the market”.⁸⁴

European Union: Reportedly, proposals in 2003 by the European Commission to displace RBC laws in member states were set aside because of opposition from some member states. The European Commission had based its proposals on the view that sales promotions are essential to the development of cross-border trade in products and services.⁸⁵

United States: The US does not have RBC laws at the national level, but some states have enacted RBC or RBC “plus” laws for gasoline retailing in recent years with various levels of enforcement efforts.⁸⁶ There are a scattering of other state RBC laws as well.⁸⁷ The state RBC laws set the price standard at the acquisition price or the acquisition price plus a required retail margin. One of the rationales for the restrictions is a concern that gasoline

processors (oil companies) are favouring the retail outlets that they own by allowing affiliated retailers to operate at a loss (cross-subsidisation). The claim is that independent retailers are being drive out of business by affiliated retailers because of cross-subsidisation of affiliated retail outlets. This is viewed either as a prelude to raising retail prices to benefit the parent firm or squeezing independent retailers so that the suppliers can acquire them at below-market prices.⁸⁸

Restrictions on retail prices are not a new issue in the US For a large part of the 20th century, the US had mandatory RPM (Fair Trade) laws. These laws did not recede until the 1970s and treatment of other vertical restraints has varied considerably as views about the procompetitive or anticompetitive effects of these restraints have shifted back and forth.⁸⁹ Views about the appropriate price level for predatory pricing have also varied over time as have views about the general likelihood of predatory pricing.⁹⁰

6. Alternative policy classifications for RBC laws

It can be argued that the effect of RBC laws is to protect competitors rather than competition, but this criticism is really too broad a description of both the likely effects and the most widely publicised court decisions that support this argument.⁹¹ RBC laws do not generally protect entrants from incumbents or large firms from small firms. Rather, the history and application of RBC laws tend to support the view that RBC laws protect small, established firms following a high-price strategy from large entrants following a low-price strategy. If such is the case, RBC laws may well be incorrectly classified as competition laws. If RBC laws are not competition laws, are there one or more classifications that provide a better fit?

One candidate is historic site preservation programs. The expressed goal of these programs is to protect historically significant buildings from demolition or renovation that detracts from their historical role. Individual structures or groups of structures may be designated. Financial assistance may be made available to repair or to maintain historic structures. If the historic significance of the structures involves their use for specific resale activities, resellers located in these buildings may benefit from government or charitable repair and maintenance funding. To the extent that several structures or a section of a city receives a historic preservation designation, resellers in the area are protected from competition by firms whose scale, marketing, or operating approaches are incompatible with historic preservation.

Historic preservation laws are not generally within the scope of competition authorities. In the UK, for example, responsibility for the commercial viability of downtown areas rests with the Office of the Deputy Prime Minister.⁹² In the

US many historic preservation programs are privately supported or funded by state or municipal governments.

Another candidate is zoning or land use planning. Both policies are generally used to separate incompatible activities. Residential areas are often separated from retail and manufacturing activities that are noisy, polluted, or involve high automobile traffic volumes. Residential areas are often considered compatible with small retail establishments. Residents enjoy lower transportation and time costs if they shop locally. Residential zoning protects resellers in these areas from having to compete as directly with resellers located in non-residential areas. Residential neighbourhood resellers are typically smaller and more traditional retailers. Residential zoning can prevent large resellers from locating in residential neighbourhoods on the basis of traffic congestion or aesthetics. The OECD Economic Survey of France, 2005, indicates the French RBC laws had their origins in a desire to protect small “traditional” retailers in town centers (as well as to regulate relationships between producers and distributors). The report then advises, “If such protection is felt to be necessary it should be through general zoning laws (without the current arrangement in which representatives of current traders have a direct voice in granting planning permission for large retail outlets).”

Another candidate is social externalities policy. Some countries have concluded that particular sizes or classes of businesses warrant public support either because they are intrinsically valuable or because one or more significant market failures apply to that size or class of business. A common example is small farms. Small farms are not generally resellers, but another class of firms sometimes designated for attention is small businesses, including small resellers. Government programs that assist small businesses are at least a partial match to the effects of RBC laws. Both provide a competitive advantage for qualified firms relative to their rivals. In the case of government-financed small business programs, the effect may be to lower operating costs, improve access to capital or improve business acumen. All allow qualified firms to compete more aggressively with their non-qualified rivals.⁹³ In contrast, RBC laws appear to have their primary effect through handicapping rivals of the qualified firms —preventing them from using some of the sales and marketing techniques that would be most effective for the non-qualified rival firms. As a general proposition, a policy of helping one group of firms to improve efficiency appears to be preferable to one that creates inefficiencies among non-qualified rivals of the favoured group. The former policy approach may benefit consumers by increasing competition, and it is likely to be more efficient because it does not purposefully waste resources.

Some governments have reached similar conclusions about alternative policy frameworks that address some non-competition policy objectives associated with RBC laws. For example, the UK’s Office of Fair Trading observed in

its recent conclusions about reforms in grocery trade rules,⁹⁴ “Some stakeholders have raised concerns which are outside the OFT’s remit. For example, it is for DEFRA [Department of Environment, Food, and Rural Affairs] to consider issues related to the viability of the rural economy and the Office of the Deputy Prime Minister to consider planning matters which have an impact on the diversity of local high streets”. The OFT report also notes that concerns that supermarket chains will cut off imports from developing countries should be addresses by the Department of International Development working with these countries to meet the higher quality standards developed by these resellers.

In the case of the three policy instruments discussed above, the match between the effects of RBC laws and those instruments appears to be at least as strong as the match between RBC laws and other competition laws. This may reflect a shift in the economic understanding of what competition means. Competition has come to be understood as a more dynamic process such that laws favouring artificial preservation of competitors are now a poor fit with other competition laws. As mentioned previously, an important component of this shift has been greater appreciation of the importance of consumer information in effective competition.

The recommendation that flows from these examples is that policymakers may be able to pursue the non-competition policy objectives that are now associated with RBC laws, but without resorting to RBC laws that are likely to impede effective competition.

If RBC laws remain in place and under the administration of the competition agency, consumers are most likely to benefit if the agency focuses enforcement efforts on instances, if any, where the behaviour violates the RBC laws and is likely to be a form of predatory foreclosure. If the RBC laws remain in place, but administration is transferred to another agency, consumers are likely to benefit if the competition agency retains the authority to intervene when enforcement is likely to harm consumers.

7. Conclusion

RBC laws appear to be a poor match for the consumer welfare standard espoused for competition laws by most competition authorities. Because RBC laws do not involve a recoupment test, they are likely to impede the entry and growth of resellers with low-price/high-volume strategies that can increase consumer welfare. There are also many legitimate business reasons why resellers may offer products at RBC prices. Many of these involve consumer information and supplier reputation issues. Carving out RBC law exemptions for legitimate business practices is likely to lead to significant administrative costs and enforcement uncertainties. When predatory foreclosure laws are in place, RBC laws are likely to do consumers more harm than good. Further, RBC

laws can contribute to a regulatory stagnation associated with slower economic growth and higher unemployment rates.

Even though RBC laws may be a poor match for the consumer welfare standard of competition laws, they may fit more closely with other public policies regarding historic preservation, land use and social externalities. Examination of RBC laws as an instrument with which to pursue these other policy goals does not yield a particularly favourable conclusion, but does suggest that to the extent RBC laws are really intended to pursue these non-competition policy goals, there may be ways to do so by taking more direct and transparent initiatives without causing the potential consumer harm associated with RBC laws.

For both of these sets of reasons, RBC laws are good candidates for sunset reviews by OECD member countries.

Notes

1. RPM is generally regarded as a vertical restraint that stems from private contractual agreements between manufacturers and resellers. Government policies regarding private RPM can range from outlawing private RPM to making compliance with RPM compulsory if any resellers wish to accept a supply arrangement with RPM provisions.
2. The terms consumer(s) and retail customer(s) are used interchangeably in the text.
3. Unless treated separately, the term “laws” is intended to encompass, laws, regulations and efforts to enforce them.
4. The public choice literature is based on this proposition. See, Jac C. Heckelman, Ed. *Readings in Public Choice Economics* (2004) including article by James Buchanon, Robert Tollison and Gordon Tullock.
5. A total welfare approach including both consumer and producer effects is also likely to be effective for this purpose, although the determination may be more difficult and costly to perform. See Margaret Sanderson, “Remarks Prepared for the Federal Trade Commission Hearings on Global and Innovation-Based Competition” (2 November 1995) available at www.ftc.gov/opp/global/sandersn.htm.
6. Economic evaluation of consumer search behaviour generally finds that consumers search more when the variance of prices is higher. When consumers search more, a seller finds a greater response when it reduces prices. In contrast, when consumers do not actively search for lower prices, sellers find it less rewarding to lower prices. Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organisation* 3rd Ed. (2000), pp. 431-450.
7. Laws against price discrimination by manufacturers and wholesales also raise an economic concern because they are likely to decrease price dispersion and, therefore reduce future consumer search behaviour and price sensitivity (elasticity) of demand.
8. Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organisation* 3rd Ed. (2000), pp. 431-450 and references therein.

9. Even in this situation, the other values to consumers, from unusually low reduced prices such as increased search behaviour or the value of product or retailer information obtained because of lower prices may predominate.
10. A useful review and comparison of monopoly and monopsony market power is Roger G. Noll, "Buyer Power' and Economic Policy", *Antitrust Law Journal* 72:2 (2005), pp. 589-624. An interesting direct defence of large retailer treatment of manufacturers, stressing the long term relationships with suppliers that lower manufacturers' costs and risk, is S. Robson Walton, "Wal-Mart, Supplier Partners, and the Buyer Power Issue", *Antitrust Law Journal* 72:2 (2005), pp. 509-527.
11. Laws against price discrimination can be viewed as an attempt to address monopsony power by preventing manufacturers from offering discounts that are not justified by costs that the manufacturer saves as a result of the buyer performing some service that the manufacturer would otherwise have to provide. Concerns about refusals of manufacturers to deal with some buyers due to exercise of monopsony power by one or more other buyers can be viewed as an extreme form of price discrimination by the manufacturer. Both prohibitions are more likely to benefit consumers and less likely suppress beneficial price cutting, if they are accompanied by market power analysis (including consideration of market definition, market structure, and entry at the retail (resale) level of the market. An interesting case from this perspective is the FTC case against Toys "R" Us for inducing manufacturers not to offer the most popular toys to resellers with low markups on these items. Evidence developed in the case indicate that Toys-R-Us found it more profitable to prevent its discount store rivals from acquiring popular toys than to compete with them in selling these items. "Boiled down to essentials, this case is about how Toys""R" Us ("TRU"), the largest toy retailer in the United States, responded to a new type of competition in toy retailing posed by wholesale clubs ("clubs"), an innovative class of discount retailers. Instead of meeting this new competition in the market place, TRU communicated with all the toy manufacturers that supplied both TRU and the clubs, and induced many suppliers to agree – with TRU and each other – either that they would not sell to the clubs at all, or more usually that they would sell on disadvantageous terms and conditions. TRU's goal was to prevent consumers from comparing the price and quality of products in the clubs to the price and quality of the same toys displayed and sold at TRU, and, thereby, to reduce the effectiveness of the clubs as competitors. Opinion of the Commission in the Matter of Toys "R" Us, FTC Docket No. 9278 (1998), available at www.ftc.gov/os/1998/10/toyspubl.pdf.
12. The articles from the symposium: buyer power and antitrust published in the *Antitrust Law Journal* 72:2 (2005) amply illustrate that monopsony market power is potentially as great a concern as monopoly market power with the exception of where monopoly market power already exists. Some of the articles do not deal with this important exception prominently.
13. Often the marginal or variable costs of a reseller will be above the acquisition costs because the acquisition costs are simple a component of the marginal or variable costs. If so, RBC sales by a reseller will also be below the predatory exclusion pricing standard. However, acquisition costs are not necessarily variable. For example, if a reseller's supply contract with a manufacturer contains substantial "take-or-pay" provisions, the total acquisition costs do not vary with volume over the range of the take-or-pay provision. If so, a reseller could violate the RBC laws based on average unit costs but not violate the predatory foreclosure pricing standard based on marginal or variable costs. Take-or-pay supply contracts create an enforcement problem for RBC laws. RBC laws use the invoice price, but the invoice price per unit can be much lower than the actual per unit acquisition cost if

the reseller does not take all of the quantity specified in the supply contract. In this situation, failure to consider end-of-year cumulative adjustments can result in failure to transactions that are far below acquisition costs.

14. The background note, country submissions, and the aide-memoire are available at www.oecd.org/dataoecd/35/7/1920261.pdf.
15. This is termed double marginalisation. If the economic concern is double marginalisation, the potential RPM remedy is a price ceiling not a price floor. Hence, neither RPM minimum prices nor RBC laws are directly relevant to concerns about double marginalisation.
16. For a text treatment of vertical restraints and references, see Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organisation* 3rd Ed. (2000), Chapter 12, and W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* 3rd Ed. (2000), Chapter 8. Also see Thomas R. Overstreet, Jr., *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics Staff Report to the Federal Trade Commission (1983), and FTC Commissioner Pamela Jones Harbour, "Vertical Restraints: Federal and State Enforcement of Vertical Issues" (March 2005) available at www.ftc.gov/speeches/harbour/050329vertical.pdf. For an discussion of free riding with respect to gray market imports see "Free Trading or Free Riding: An Examination of the Theories and Available Evidence on Gray Market Imports", *World Competition Law and Economics Review* 32 (February 1988), pp. 75-92. Reprinted in Ruth Towse and Rudy Holzhauser, Eds., *The Economics of Intellectual Property*, Vol. 4, *Competition and International Trade* (2002).

The suboptimal services concern is particularly compelling if all consumers require these services to make efficient purchase decisions about a product or the presence of these services strengthens inter-brand competition – but resellers with low prices do not provide these services. Instead, consumers obtain the necessary services from resellers with higher prices and higher services, but buy from the low-priced resellers. In this scenario, low-priced resellers are said to be "free riding" on the resellers that provide the services that consumers need. Consumers potentially can be left with no providers of the required services. The result can be market failures such as inefficient purchase decisions, unsafe use of the product, or insufficient demand to keep any manufactures in business. A similar concern arises if resellers find that the costs of providing services for some products in a line of products are greater than for others. If so, some resellers may offer only the subset of products that do not require much service. This is termed "cream-skimming". Consumers then may be left with no resellers that carry a full line of products because the full line resellers exit the market. In this scenario, consumer choice could be restricted to the low-service subset of products.

17. Thomas R. Overstreet, Jr., *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics Staff Report to the Federal Trade Commission (1983), and FTC Commissioner Pamela Jones Harbour, "Vertical Restraints: Federal and State Enforcement of Vertical Issues" (March 2005) available at www.ftc.gov/speeches/harbour/050329vertical.pdf.
18. In addition to vertical restraints that are arranged or enforced by horizontal coordination of competitors, some vertical restraints that may be procompetitive when employed by a few suppliers, can take on anticompetitive horizontal effects when employed by all or most suppliers. See, for example, Jonathan Baker, "Vertical Restraints with Horizontal Consequences: Competitive Effects of Most-Favored-Customer' Clauses", *Antitrust Law Journal* 64 (Spring 1996), pp. 517-534.

19. Mikheil Gogeshvili, "Resale Price Maintenance – A Dilemma in EU Competition Law", *Georgian Law Review* (2002), pp. 281-319, available at www.geplac.org/publicat/law/glr02n2-3e/p-281epdf.
20. For a discussion of how RBC laws can be viewed as a form of vertical restraint, see Marie-Laure Allain and Claire Chambolle, "Forebidding Below Cost Pricing for Retailers: A Strategic Inflationary Mechanism" (February 2004), presented at the University of Toulouse Industrial Organization and The Food-Processing Industry Conference, June 2004) available at www.toulouse.inra.fr/centre/esr/semUnite/papsem/chambolle.pdf, and "Loss-Leaders Banning Laws as Vertical Restraints", Institut National de la Statistique et des Etudes Economiques, Centre de Recherche en Economie et Statistique, Working Paper No. 2004-19 (2004) available at www.crest.fr/doctravail/document/2004-19.pdf. If free riding is a legitimate concern, RPM price floors are more likely to be effective than RBC laws. The RPM price floor can be set and adjusted to compensate resellers for the level of customer service that is optimal for the whole vertical chain of production. If minimum-price RPM is not available, manufacturers may be able to turn to other approaches to address the problem. Potential examples include increased advertising to establish the reputation and proper use of a product; payments (or discounts) by manufacturers for services provided by retailers; alternative sources of product information; vertical integration into retailing; monitoring of customer service levels; and product differentiation between geographic market areas.
21. See, for example, Michael Lynch, Ross M. Miller, Charles R. Plott and Russell Porter, "Product Quality, Consumer Information and 'Lemon' in Experimental Markets", in Pauline M. Ippolito and David T. Scheffman, Eds., *Empirical Approaches to Consumer Protection Economics: Proceedings of a Conference Sponsored by the Bureau of Economics, Federal Trade Commission* (1986), pp. 251-306.
22. This is also an assumption in a model in which resellers have an incentive to offer loss leaders in general. See Patrick Paul Walsh and Ciara Whelan, "Loss Leading and Price Intervention in Multiproduct Retailing: Welfare Outcomes in a Second-Best World", *International Review of Law and Economics* 19:3 (September 1999), pp. 333-347.
23. In markets with many new or infrequent customers, deceptive practices are more likely to persist because a substantial portion of customers are likely to be unaware that sellers are engaging in deception.
24. The FTC Guides and consumer protection rules are available at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?sid=3ad5b48a02eb1707974872e00175bbb5&c=ecfr&tpl=/ecfrbrowse/Title16/16cfrv1_02.tpl. A list the US consumer protection statutes is available at www.ftc.gov/ogc/stat3.htm. A description of the unavailability rule regarding rain checks is available at <http://consumerlawpage.com/brochure/45.shtml>.
25. The US FTC's consumer protection program includes a data base of complaints that helps to guide the agency's rule making, law enforcement and consumer education. RBC related complaints do not indicate that this is an area in need of increased attention. The most recent available FTC "Performance and Accountability Report" (fiscal year 2004) is available at www.ftc.gov/opp/gpra/2004parreport.pdf. Pages 29-40 cover consumer protection. There is also an empirical literature on the effectiveness of enforcement of consumer protection laws. A useful collection of early work in this area is Pauline M. Ippolito and David T. Scheffman, Ed. *Empirical Approaches to Consumer Protection Economics* (1986). Also see Janis K. Pappalardo, "The Role of Consumer Research in Evaluating Deception: An Economist's Perspective", *Antitrust Law Journal* 65:3 (Spring 1997), pp. 793-812.

26. Most of these also apply to resale prices that are below RPM price floors.
27. For alternative discussion of these three explanations for RBC sales, see Marie-Laure Allain and Claire Chambole, "Forebidding Below Cost Pricing for Retailers: A Strategic Inflationary Mechanism" (February 2004), presented at the University of Toulouse Industrial Organisation and The Food-Processing Industry Conference, June 2004, available at www.toulouse.inra.fr/centre/esr/semUnite/papsem/chambole.pdf.
28. Formally, a Type I error occurs if the null hypothesis is true, but it is rejected. A Type II error occurs if the null hypothesis is false, but it is accepted.
29. See, for example, Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decisions Making* 3rd Ed. (2002), Chapter 4.
30. Generally, products or services can have search, experience or credence characteristics. Search characteristics can be determined before the purchase. Experience characteristics can only be determined post purchase, but can be relatively easily and objectively determined (how fuel efficient in this particular automobile). Credence characteristics are difficult to determine even after the purchase because they are difficult to measure (pollution from a car, for example) or involve probabilities over extended use (health risks). For a discussion of the development of economic perspectives on quality and consumer knowledge, see Gordon Mills, *Retail Pricing Strategies and Market Power* (2002), Chapter 4.
31. Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* 3rd Ed. (2002), p. 178.
32. Patrick Paul Walsh and Ciara Whelan, "Loss Leading and Price Intervention in Multiproduct Retailing: Welfare Outcomes in a Second-Best World", *International Review of Law and Economics* 19:3 (September 1999), pp. 333-347.
33. Thomas R. Overstreet, Jr., *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics Staff Report to the Federal Trade Commission (1983), Section VI.E. Also see the discussion of the evolution of retail competition through new store formats in FTC Commissioner Pamela Jones Harbour, "Vertical Restraints: Federal and State Enforcement of Vertical Issues" (March 2005) available at www.ftc.gov/speeches/harbour/050329vertical.pdf.
34. Competition between resale formats has been a special area of attention in the work of economist Robert Steiner. See, for example, Robert L. Steiner, "How Manufacturers Deal with the Price-Cutting Retailer: When Are Vertical Restraints Efficient," *Antitrust Law Journal* 65:2 (Winter 1997), pp. 407-448. For discussion see FTC Commissioner Pamela Jones Harbour, "Vertical Restraints: Federal and State Enforcement of Vertical Issues," (March 2005) available at www.ftc.gov/speeches/harbour/050329vertical.pdf.
35. Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decisions Making* 3rd Ed. (2002), p. 90 and Chapter 4 more generally. The *Horizontal Merger Guidelines* issued by the US Department of Justice and the Federal Trade Commission (1992, revised 1997) give prominence to the effect of switching costs on price sensitivity and substitution in delineating the relevant product and geographic market (Section 1.11 and 1.21).
36. See, for example, Morris Engelson, *Pricing Strategy: An Interdisciplinary Approach* (1995), pp. 46-47.
37. Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decisions Making* 3rd Ed. (2002), Chapter 12.
38. Establishing customer loyalty is the mirror image of entry, but both are legitimate business objectives that are part of the normal life cycle of products and firms.

Although some entry may be hit-and-run entry against an incumbent attempting to exercise market power, other entry involving sunk costs presumes that the entrant will become an established supplier over time. In a market with heterogeneous demand, sustainable entry may depend on catering closely to the tastes of a subset of customers. Once the customers become acquainted with the product, the supplier's financial viability may depend on being able to reduce marketing costs once consumers are familiar with the attributes of the products of the new supplier.

39. For discussion, see Ramon Caminal and Adina Claiici, "Are Loyalty-Rewarding Pricing Schemes Anti-competitive", manuscript (March 2005), available at www.uib.es/depart/deeweb/seminaris/pdfs0405/caminal.pdf.
40. See Patrick DeGraba, "Volume Discounts, Loss Leaders and Competition for More Profitable Customers", FTC Bureau of Economics Working Paper 260 (April 2003) available at www.ftc.gov/be/workpapers/wp260.pdf, for this interpretation. It is worthy of note, that discounting to lower cost customers can be a means of departing from a price discrimination strategy. Charging the same price to customers with different costs is just as much a form of price discrimination as charging higher prices to one group of customers even though the costs of serving them are the same as those to serve other customers.
41. Note that price discrimination can involve either charging the same price when costs of serving customers differ or charging different prices when cost of serving customers are the same (or some combination of the two).
42. For example, see Gordon Mills, *Retail Pricing Strategies and Market Power* (2002), Chapters 1-5.
43. For a text treatment, see for example, Dennis W. Carlton and Jeffrey M Perloff, *Modern Industrial Organisation* 3rd Ed. (2000), Chapt. 9. There remains considerable controversy over the importance and competitive effects of price discrimination. See, for example, the papers from the symposium on competitive price discrimination published in the *Antitrust Law Review* 70:3 (2003) and James C. Cooper, Luke Froeb, Daniel O'Brien and Steven Tschantz, "Does Price Discrimination Intensify Competition? Implications for Antitrust", *Antitrust Law Review* 72:2 (2005), pp. 327-373.
44. See Max Sutherland and Alice Sylvester, *Advertising and the Mind of the Consumer: What Works, What Doesn't, and Why* 2nd Ed (2000), pp. 21-23 and 200; Michael T. Elliot and Paul S. Speck, "Consumer Perception of Advertising Clutter and Its Impact Across Various Media", *Journal of Advertising Research* 38 (1998), pp. 1-3; Robert J. Kent, "Competitive Clutter in Network Televisions Advertising: Current Levels and Advertiser Responses", *Journal of Advertising Research* 35 (1995), pp. 49-57; and John C. Hilke and Philip B. Nelson, "Noisy Advertising and the Predation Rule in Antitrust Analysis", *American Economic Review*, 74:2 (May 1984), pp. 367-371.
45. Thomas T. Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing: A Guide to Profitable Decisions Making* 3rd Ed. (2002), pp. 100-101. It is also useful to consider why resellers might choose to offer discount prices from time to time even if their costs do not vary and the price sensitivity of demand does not vary. One explanation is that resellers establish a high price outside of sale periods in order to try to establish the worth of the product on consumers' minds. For some products, consumers may use the normal price as a signal of quality or even a value from the products status as a luxury item. If consumers view the normal price as the products' worth, then they may respond more substantially to even a small price reduction during a sale

- period. For discussion see Gordon Mills, *Retail Pricing Strategies and Market Power* (2002), pp. 59-60 and 69-72.
46. Retailers in areas with less intensive competition may be less concerned about manufacturer's price increases as long as prices increase for all resellers in the area by the same amount. Retailers may hold this view because they believe that when all retailers raise prices simultaneously because of increased costs, the prices can be passed along to consumers without substantial volume losses. See, for example, David Scheffman, "Sources of Information and Evidence in Merger Investigations" (14 June 2002) available at www.ftc.gov/speeches/other/scheffmanabanybar.pdf.
47. Some products are likely to be better loss leaders than others. Good loss leaders are often products that are frequently purchased so consumer have in mind the typical price for the item. Good loss leaders are often products with consistent, well-know quality so that customers do not worry that the lower price is being offered because the quality is lower. See John C. Hilke and Philip B. Nelson, "Retail Featuring as a Strategic Entry or Mobility Barrier in Manufacturing", *International Journal of Industrial Organisation*, 9 (1991), pp. 533-44.
48. United States Treasury, Internal Revenue, "Accounting Periods and Methods", Publication 538 (2004) available at www.irs.gov/publications/p538/ar02.html and John C. Hilke, "Firm Size and Regulatory Compliance Costs: The Case of LIFO Regulations", Bureau of Economics Report to the Federal Trade Commission (1984).
49. Olivier Boylaud and Giuseppe Nicoletti, "Regulatory Reform in Retail Distribution", *OECD Economic Studies* No. 32 (2001).
50. Olivier Boylaud and Giuseppe Nicoletti, "Regulatory Reform in Retail Distribution", *OECD Economic Studies* No. 32 (2001).
51. In a dynamic retail sector, the meaning of "traditional retailers" may change over time. For example, before the wide-spread use of automobiles, retailers in rural areas were often general stores at which consumers presented a list of items and clerks assembled the desired items from inventories behind the counter. In this context, consumer self service from open inventories was an innovation, even though this practice now predominates. Selection from behind the counter survives, however, for some highly customised products, some very expensive products that are subject to pilfering, and some products that are illegal to sell to minors.
52. For example, see Robert L. Steiner, "Exclusive Dealing + Resale Price Maintenance: A Powerful Anticompetitive Combination", *Southwestern University Law Review* 33 (2004), pp. 447-476, available at www.antitrustinstitute.org/recent2/347.pdf#search=Robert%20L.%20Steiner%20and%20retail%20innovation.
53. See, Virginia Postrel, "Lessons in Keeping Business Humming, Courtesy of Wal-Mart U" *New York Times* (February 28, 2002) available at www.dynamist.com/articles-speeches/nyt/walmart.html, and McKinsey Quarterly (2002), available at www.mckinseyquarterly.com/article_abstract.aspx?ar=1152&L2=20.
54. The leading initial treatment is Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975). See also, for example, John Stuckey and David White, "When and When Not to Vertically Integrate", *McKinsey Quarterly* 3 (1993) and Wesley H. Higaki, "Applying An Improved Economic Model to Software Buy-Versus-Build Decisions", *Hewlett-Packard Journal* 46:4 (1995), pp. 61-66.
55. See also the discussion of transfer pricing in Section V's description of RBC laws in France.

56. S. Robson Walton, "Wal-Mart, Supplier Partners, and the Buyer Power Issue", *Antitrust Law Journal* 72:2 (2005), pp. 509-527. Discussions of Wal-Mart efficiencies are contained in Harvard Business School case studies 9-794-024 (1996); 9-387-018 (1989) and N9-799-188 (1999), cited in Emek Basker, "Selling a Cheaper Mousetrap: Wal-Mart's Effect on Retail Prices" (March 2005). University of Missouri Working Paper No. 04-01. Available at <http://ssrn.com/abstract=484903>.
57. In contrast to inefficient restrictions on firm behaviour, regulations that force firms to internalise negative and positive externalities or address market power concerns in natural monopoly situations can help to steer innovation and entry in economically efficient ways. For example, Giuseppe Nicoletti, "Regulation in Services: OECD Patterns and Economic Implications", OECD Economics Department Working Paper No. 287 (8-February-2001) supports the view that the pace of deregulation should be evaluated relative to the actual remaining natural monopoly (or other market failure) elements in an industry rather than in absolute terms. Similarly, regulations properly classified as competition laws can facilitate innovation and entrepreneurship by curbing efforts by incumbent firms to impede entry or the growth of competition from established rivals. Intellectual property regulation can increase incentives to innovate and disclose new technologies so that others may develop them further, although these laws simultaneously also can allow firms to exercise market for a limited period of time. The use of the word "can" in this footnote is a potential subject of controversy. For discussion of the optimistic versus pessimistic views of government regulatory intervention and an empirical result favouring the pessimistic viewpoint using regulatory data sets other than the OECD data on regulation, see Tue Gorgens, Martin Paldam and Allan Wurtz, "A Study of Public Regulation and Growth", Working Paper 2003-14, Department of Economics, Aarhus University (5-October-2004) available at ftp://ftp.econ.au.dk/afn/wp/03/wp03_14.pdf. The authors conclude that economic growth shows an inverse relationship to regulation and does not indicate that any actual (as opposed to conceptual) regulatory environment improves economic growth rates.
58. OECD, *Economic Survey of New Zealand*, 2005 (July 2005) and *Economic Survey of France*, 2005 (June 2005).
59. Virginia Postrel, "Lessons in Keeping Business Humming, Courtesy of Wal-Mart U" *New York Times* (February 28, 2002) available at www.dynamist.com/articles-speeches/nyt/walmart.html.
60. OECD, *OECD Economic Studies*, No. 32, *Special Issue on Regulatory Reform* (2001). Comparisons of the OECD data to regulatory comparison based on subjective survey responses are discussed in Giuseppe Nicoletti and Frederic L. Pryor, "Subjective and Objective Measures of the Extent of Governmental Regulations", manuscript (5-December-2001), available at www.aei-brookings.org/admin/authorpdfs/page.php?id=130. The authors report positive correlations of between .55 and .67 between the three sets of measure of product market regulation.
61. Giuseppe Nicoletti, "Cross-country Regulations Patterns and Their Implications for Macroeconomic and Sectoral Performance", in Giuliano Amato and Laraine L. Laudati, Eds., *The Anticompetitive Impact of Regulation* (2001), pp. 278-313. The descriptive materials about the OECD International Regulation Database are from this source as well.
62. Giuseppe Nicoletti and Stefano Scarpetta, "Regulation, Productivity, and Growth: OECE Evidence", World Bank Policy Research Paper 2944 (January 2003).

63. OECD Economics Department, "The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Finance: The Case of the United States and the European Union", Working Paper 432 (26 May 2005).
64. Alberto Alesina, Silvia Ardagna, Giuseppe Nicoletti and Fabio Schiantarelli, "Regulation and Investment" Harvard Institute for Economic Research Discussion Paper 1990 (2002), available at <http://post.economics.harvard.edu/hier/2002papers/2002list.html>.
65. See OECD, "Product Market Regulation in OECD Countries: 1998 to 2003", *Economic Policy Reforms, Going for Growth* (2005), Chapter 4, for discussion of changes in relative levels of regulation among OECD countries.
66. Giuseppe Nicoletti, "Cross-country Regulations Patterns and Their Implications for Macroeconomic and Sectoral Performance", in Giuliano Amato and Laraine L. Laudati, Eds., *The Anticompetitive Impact of Regulation* (2001), pp. 278-313.
67. OECD, Predatory Foreclosure Roundtable Background Note, Section 2.4.
68. UK Competition Commission, "Legislation Against Buyer Power in other European Countries", available at www.competition-commission.org.uk/rep-pub/reports/2000/fulltext/446a11.10.pdf.
69. The 2004 efforts to revise the 1996 laws were superseded by a government led agreement among manufacturers and resellers to reduce resale prices on some 4 000 items sold in grocery outlets. "France's Visible Hand," *TIME Europe* (20 June 2004) available at www.time.com/time/europe/magazine/artucke/0,13005,901040628-655393,00.html, and Jean Christophe Grall, Thomas Lamy and Jonathan Wagstaff, "Questioning the General Prohibition on Resale at a Loss and Its Effects on Competition, the French Experience: Simple Words for an Intricate Problem" *European Community Law Review* (2005), pp. 201-204.
70. See, for example, Enrico Colla, "Legislation Commerciale, Marges Arrieres et Concurrence par les Prix dans la Distribution en France. Quels modèles d'explication?" available at <http://venus.unive.it/dea/ricerca/convegni/markpa05/Materiali/Paper/Fr/Colla.pdf>, and European Union, *Economic Reform in France* (2004), pp. 5, available at http://europa.eu.int/comm/economy_finance/epc/documents/2004/nationalreports/france. Previous versions of the loi Galland also contained provisions against RBC transactions. OECD, *Regulatory Reform Review of France* (1 April 2004), Chapter 3, p. 17.
71. OECD, *Regulatory Reform Review of France* (1 April 2004), Chapter 3, pp. 17-18.
72. UK Competition Commission, "Legislation Against Buyer Power in other European Countries", available at www.competition-commission.org.uk/rep-pub/reports/2000/fulltext/446a11.10.pdf.
73. Marie-Laure Allain and Claire Chambolle, "Forebidding Below Cost Pricing for Retailers: A Strategic Inflationary Mechanism" (February 2004), presented at the University of Toulouse Industrial Organisation and The Food-Processing Industry Conference, June 2004) available at www.toulouse.inra.fr/centre/esr/semUnite/papsem/chambolle.pdf, and "Loss-Leaders Banning Laws as Vertical Restraints", Institut National de la Statistique et des Etudes Economiques, Centre de Recherche en Economie et Statistique, Working Paper No. 2004-19 (2004) available at www.crest.fr/doctravail/document/2004-19.pdf.
74. Dobson Consulting, "Buyer Power and Its Impact on Competition in the Food Retail Distribution Sector of the European Union", European Commission Study Contract No. IV/98/ETD/078 (May 1999), Chapter 8, available at <http://europa.eu.int/cinn/>

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75. Marie-Laure Allain and Claire Chambolle, "Forebidding Below Cost Pricing for Retailers: A Strategic Inflationary Mechanism", manuscript (February 2004) presented at the University of Toulouse Industrial Organisation and The Food-Processing Industry Conference, June 2004, available at www.toulouse.inra.fr/centre/esr/semUnite/papsem/chambolle.pdf, and "Loss-Leaders Banning Laws as Vertical Restraints", Institut National de la Statistique et des Etudes Economiques, Centre de Recherche en Economie et Statistique, Working Paper No. 2004-19 (2004) available at www.crest.fr/doctravail/document/2004-19.pdf, and Olivier Macard, "France", in *Ernst and Young Global Pricing Trends 2004* (2004) available at http://www2.eycom.ch/publications/items/rcp_pricingtrends2004_report/en.pdf.
 76. UK Competition Commission, "Legislation Against Buyer Power in other European Countries", available at www.competition-commission.org.uk/rep-pub/reports/2000/fulltext/446a11.10.pdf. Germany continues to permit strict RPM for books, although the European Commission has challenged some applications of the law to book sellers outside of Germany. Malcom MacLaren, "Is the Price Right: The European Competition Law Dispute over National Systems of Fixed Book Prices", *German Law Journal* 13:1 (August 2001) available at www.germanlawjournal.com/article.php?id=75.
 77. OECD, *OECD Reviews of Regulatory Reform, Germany: Consolidating Economic and Social Renewal* (2004), pp. 47 and 94.
 78. Wal-Mart may be a large firm in total global sales, but its 2% share of food sales in Germany and the much larger shares of Aldi and several other grocery retailers (Jack Ewing, "Wal-Mart: Struggling in Germany", *Business Week* (11 April 2005) available at www.businessweek.com/magazine/content/05_15/b3928986_ms054.htm) suggests that Wal-Mart's prospects for recoupment from RBC sales are at least questionable.
 79. Patrick Paul Walsh and Ciara Whelan, "A Rationale for Repealing the 1987 Groceries Order", *Economic and Social Review* 30:1 (January 1999), pp. 71-90.
 80. The Joint Committee on Enterprise and Small Business submission is available at www.oireachtas.ie/documents/comittes29thdai/jcesb/Sub210705.doc. Also see, Consumer Strategy Group, "The Groceries Order Pro's and Cons" (2005) available at www.irishconsumer.ie/report/forward/groceries_procon.html.
 81. Competition Authority, "Anti-Consumer Groceries Order has Greatest Effect on Lower Income Families", news release (13 September 2005).
 82. Alan Collins and Kostas Oustapassidis, "Below Cost Legislation and Retail Performance," *Agribusiness Discussion Paper No. 15*, Department of Food Economics, University College, Cork (April 1997). This paper also contained a useful history of the development of RBC laws in Ireland. Also see Patrick Paul Walsh and Ciara Whelan, "A Rationale for Repealing the 1987 Groceries Order", *Economic and Social Review* 30:1 (January 1999), pp. 71-90, and "Loss Leading and Price Intervention in Multiproduct

- Retailing: Welfare Outcomes in a Second-Best World”, *International Review of Law and Economics* 19:3 (September 1999), pp. 333-347.
83. UK Office of Fair Trading, “Supermarkets: The Code of Practice and Other Competition Issues, Conclusions” (August 2005).
 84. A less favourable interpretation of buyer power in the U.K. grocery trade is Paul L. Dobson, “Exploiting Buyer Power: Lessons from the British Grocery Trade”, *Antitrust Law Journal* 72:3 (2005), pp. 529-562. The author finds evidence that larger discounts are offered to larger retailers and that larger retailers may charge more for access to shelf space, but the author does not indicate how this results in harm to consumers or how remaining resellers would be able to profitably raise prices above the competitive level in the future. To the extent that resellers face effective competition in selling to consumers and create strong incentives for manufacturers to cut costs and reduce prices, resellers will pass the savings on to consumers, and consumer will benefit. See, Warren S. Grimes, “Buyer Power and Retail Gatekeeper Power: Protecting Competition and the Atomistic Seller”, *Antitrust Law Journal* 72:3 (2005), pp 563-588 at 576-577. This same source raises the possibility of price and non-price monopsony predatory foreclosure. These concerns, like the concerns about price and non-price monopoly predatory foreclosure are likely to be more accurately analysed in the context of a predatory foreclosure analysis than by RBC laws.
 85. Peter Gumbel, “Retail Politics”, *Time Europe* (9 February 2003) available at www.time.com/time/europe/magazine/article/0,13005,901030217-420981,00.html.
 86. Terry Calvani, “Predatory Pricing and State Below-Cost Sales Statutes in the United States: An Analysis”, (1 March 1999) available at www.competitionbureau.gc.ca/internet/index.cfm?itemID=1292&lg=e. Also see US Federal Trade Commission, Office of Policy Planning and Bureau of Competition, Comment to the Virginia House of Delegates regarding Senate Bill No. 458, “Below-Cost Sales of Motor Fuels” (15 February 2002), available at www/ftc.gov/be/v020011.htm. The US does have laws against various types of price discrimination that are not cost justified (Robinson-Patman Act). These laws were developed at the urging of small independent grocery stores during the 1930s when large grocery chains such as the Great Atlantic and Pacific Tea Company (A&P) were rapidly expanding.
 87. Arkansas is one such state, but in 1995 its Supreme Court ruled that loss leader sales for individual items are not necessarily predatory and may enhance rather than harm competition. See the Arkansas Supreme Court, *Wal-Mart Stores, Inc. v American Drugs, Inc et al.* Case No. 94-235, available at <http://lawlibrary.ucdavis.edu/LAWLIB/jan95/0334.html>.
 88. Terry Calvani, “Predatory Pricing and State Below-Cost Sales Statutes in the United States: An Analysis” (1 March 1999) available at www.competitionbureau.gc.ca/internet/index.cfm?itemID=1292&lg=e; US Federal Trade Commission, Office of Policy Planning and Bureau of Competition, Comment to the Virginia House of Delegates regarding Senate Bill No. 458, “Below-Cost Sales of Motor Fuels” (15 February 2002), available at www/ftc.gov/be/v020011.htm; F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* 3rd Ed. (1990), Chapter 15.
 89. Frederick R. Warren-Boulton, “Resale Price Maintenance Reexamined: *Monsanto v. Spray-Rite*” in John E. Kwoka and Lawrence J. White, *The Antitrust Revolution* (1989), pp. 371-404. Also see the references in fn 2.
 90. Terry Calvani, “Predatory Pricing and State Below-Cost Sales Statutes in the United States: An Analysis” (1 March 1999) available at www.competitionbureau.gc.ca/internet/index.cfm?itemID=1292&lg=e.

91. In particular, the 2002 Wal-Mart decision of Germany's Supreme Court.
92. UK Office of Fair Trading, "Supermarkets: The Code of Practice and Other Competition Issues, Conclusions" (August 2005).
93. Direct subsidies also allow small firms to compete in situations in which they would otherwise go out of business, but the advantage is artificial and often not self-sustaining. Assisting small businesses by providing relevant information, informing them of opportunities to realise economies of scale by cooperating with other small firms, and sharing best-practices among small firms are arguably advantages that small firms do not have primarily because of the high costs of organising small entities (a public goods problem).
94. UK Office of Fair Trading, "Supermarkets: The Code of Practice and Other Competition Issues, Conclusions" (August 2005).

Resale Below Cost Laws and Regulations

3. Summary of the Discussion

Summary of the Discussion

The Chairman opened the discussion in announcing that 12 submissions were received for this roundtable and made three introductory remarks. First, delegations seem to have sorted themselves in three different groups: a group of delegations that view Resale Below Costs (RBC) in fact as a useful component of competition law; a second set of countries that generally view RBC laws as being contrary to the consumer interest and to the competition interest and are trying to reform or eliminate such laws, some of them with success some of them without much success; then a third group, those who do not have a RBC law and are trying to discourage the government or various parts of the government from contemplating the possibility of establishing such a law. A second aspect of the introduction was to point out that RBC is not defined same way in all countries. This may explain some of the differences in the views of the delegations. Some delegations were generally critical of RBC prohibitions. They view RBC laws as the closest available substitute for mandatory retail price maintenance. Yet others do not seem to be considering this close connection between resale price maintenance and reselling at a loss. Most delegations that have predatory foreclosure laws or provisions on predatory foreclosure in competition law appear to believe that they are vast improvement over RBC laws in a sense that predatory foreclosure provisions have fewer false positives. And it is clear that in some countries, and maybe in most countries, RBC laws have become more active or at least the proponents of such laws have become more active when competition has increased in the retail sector. So the good news is that competition has increased and the bad news is that the RBC laws may hinder this competition.

The Chair invited John Hilke who prepared the background note for the discussion to summarise it as an introduction to this roundtable.

John Hilke focused his remarks on 10 points. First, RBC laws are one of the 3 constraints on resale prices that a government sometimes enforces. The other 2 are predatory pricing laws and mandatory resale price maintenance. Ironically the evidence seems to suggest that RBC laws serve as a substitute for RPM, but RPM is often illegal in the same areas that have embraced RBC laws.

Second point, RBC laws are more likely to harm consumers than to benefit them, mostly because they are too blunt a policy instrument to

effectively separate pro competitive from anti competitive behaviour. RBC laws tend to contravene the general economic conclusion that consumers benefit from lower prices. And the exceptions to that rule that occurred with predatory pricing theory, free riding and consumer deception approaches require some nuanced economic evaluations that are difficult to reconcile with the way RBC laws are usually instituted.

Third point, there are a wide variety of legitimate business justifications for loss leader sales. Several of them involve conveying information to consumers that will generally improve consumer welfare. For instance an important component of retail competition is generally encouraging consumers to visit a particular store. RBC prices may in fact be a cost effective way to draw consumers and can substitute for more costly and less efficient marketing approaches.

Fourth, one of the most deleterious effects of RBC laws is the potential to reduce the dispersion of resale prices. This can cause consumers in later periods to engage in less search behaviour and consequently this can reduce the price sensitivity demand –which then creates opportunities for resellers to exercise market power.

Fifth, there is evidence that consumers do pay more when they are subject to RBC prohibitions and the Irish delegation is invited to tell a little more about their work on that regard.

Sixth, the RBC laws raised three other concerns :

- horizontal unfairness between different types of resellers; because firms that follow a low price high volume strategy tend to be more at risk for RBC prosecutions;
- the potential to raise rivals' costs by using government intervention in the market – the intervention is effectively to remove one of the most cost effective means that low-cost, high-volume retailers have to attract consumers;
- distortions in vertical integration decisions because low price vertically integrated firms are less likely to be prosecuted for RBC violations.

Number 7, RBC laws may blunt incentives for resellers to aggressively pursue efficiencies and innovations from their manufacturing suppliers. This is sometimes called the Walmart effect. This may reduce efficiencies and innovation at that level of the chain of production.

Number 8, RBC laws are likely to contribute to regulatory stagnation that leads to slower economic growth and higher unemployment rates.

Number 9, RBC laws may be good candidates for sunset reviewers by OECD members particularly if that country has already adopted some sort of predatory foreclosure law.

Number 10, when you look at the effects of RBC laws some of them seem more closely to resemble other types of regulations such as historic preservation laws, land use or social externality laws rather than other competition laws.

The Chairman put his first question to Japan, referring to a question raised about a year ago when the Committee previously discussed the issue of the consistency between the RBC laws in Japan and the consumer welfare standard generally associated with competition laws. Japan has (within its competition law) provisions whereby pricing which is lower than the cost of supply, continuing for a certain amount of time and causing difficulties to businesses is considered to be a violation of the law. Now this seems to be fairly extensive and it seems even to cover not only RBC but selling below cost in a general way. Against this background 1) Is there any idea that this kind of provision may in fact lower or limit the consumer welfare of Japanese consumers? 2) In the contribution from Japan there is an interesting development on the Matsushita Electric Company case, could Japanese delegation tell us more about this case. 3) A study group on basic problems of the Antimonopoly Act seems to have begun working in July this year. Is it going to address possible contradiction between the Antimonopoly Act and the provisions on below cost pricing?

The Japanese delegation recalled its position regarding RBC sales which has not changed since the roundtable on “Predatory Foreclosure” in October 2004. If the following three requirements are met without any significant justification, basically such conduct would be judged unjust low price sales and as such should be regulated as one of the forms of Unfair Trade Practice. The three conditions are :

- supplying commodities or services at significantly lower prices than the cost of supply;
- continuing such supply;
- tending to cause difficulties to the business activities of other competitors or entrepreneurs.

These three criteria are to be considered in their totality.

Second question regarding the Matsushita Electric case, when those conducts are related to public procurement project, JFTC generally speaking examines the following factors on a case -by-case basis.

- the position of the company which bids in extremely low price in the relevant market;
- the frequency of the low-price bidding;
- the degree of the low price;
- impact of the low-price bidding to the other procurement;

- the number of the companies which will be affected by low-price bidding.

Those factors were taken into consideration for the Matsushita Electric case and therefore the learning curve effects on costs or the promotional value you raised in your enquiries were not directly or explicitly considered by the JFTC for that particular case. Also, in this case, Matsushita's bidding price was 40 000 yens, the average of bidding price of all bidders including Matsushita was about 40 000 000 (40 million) yens, 1 000 times as much as the Matsushita's bidding price. This extremely cheap bidding price of Matsushita was another factor which we actually took into account on those occasions.

On the group study, the Japanese delegate explained that when the Diet discussed the amendment to the Antimonopoly Act early this year, members of the Parliament expressed their intention or hope that more forceful measures be considered for deterring or eliminating unfair trade practices, including unjust low-price sales, which inflict unmeasurable damages on smaller companies. It is expected that this study group will take into account this Diet resolution, but it is chaired by the Chief Cabinet Secretary and the members of that group are scholars, representatives of economic circles, consumers and other members, and the JFTC is not a regular member. Also this study group is supposed to consider various matters including the issues raised by such a Diet resolution in the next two years.

In response to the chair, the delegate confirmed that the law on unfair pricing applies not only to resale but also to the original sale of products which do not cover that cost

Chairman noted that this is the difference with France who is the next speaker. In France, the resale below cost law only concern the distribution sector and the actual resale of products. This law has been the subject of intense debate in France, which has led to a revision of the law in August 2005 that has partly amended the definition of resale below cost. Several important elements has to be borne in mind in connection with this debate:

- Firstly, how is resale below cost calculated in France: how has it been calculated previously and how is it calculated now?
- Secondly, to what extent is this law compatible or incompatible with the prohibition of resale price maintenance under competition law?
- Thirdly, could France give a somewhat fuller description of an interesting case that has come before the *Conseil de la Concurrence*, i.e. the Texas Instruments case, which has involved many different kinds of practices, in particular collective vertical practices that in fact used the prohibition on reselling below cost to promote horizontal collusion?

The French Delegate began by pointing out that in France there is – or at least that there was – a political consensus as to the need to prohibit reselling

below cost. In France, the ban on resale below cost applies to the act of reselling a product, i.e. it is forbidden to resell a product at a price lower than its purchase price. In recent months this consensus has begun to erode as a number of abuses has come to light regarding the implementation of this concept of a ban on reselling at a loss and this has led to passing a new law aimed at correcting these unwanted effects.

The various aspects of the consensus that had enabled France to adopt legislation prohibiting resale below the purchase cost has no doubt been based on three lines of argument. The first has reflected a concern for fair competition. Something had to be done to prevent or correct the structural advantage that large distributors could have over small distributors and that general distributors could have over specialised distributors. A second important aspect that underlay the consensus, which was no doubt more related to the market structure, understood as the relations between distributors and suppliers, was aimed at laying down clear rules for peaceful relations between distributors and suppliers. Lastly, a third aspect underlying the consensus and the arguments in favour of the ban on reselling below cost was more related to the benefits that consumers could supposedly derive from this situation. Consumers would somehow be protected from the risks that loss-leader pricing would be used for certain products for a very short time in order to eliminate competition and attract consumers and then of course the resale prices of these or other products would be raised either gradually or suddenly.

However, over the past few years some abuses has come to light. First, even though the first argument has been aimed at ensuring fair competition between distributors, there has been real or potential abuses stemming from the fact that all major distributors has gradually come to align their prices with the “resale below cost threshold”. (In France this threshold is calculated with reference to the purchase price of the product, to which transport costs and taxes are added, and it is prohibited for retailers/distributors to resell a product below this resale price calculated by adding the purchase price of the product + transport costs + taxes.) This has naturally given rise to doubts about whether the market was functioning properly: since the market has become totally transparent, everyone knew the authorised resale price for the product and simply aligns their prices with those of their competitors.

Secondly, with regard to more peaceful relations between distributors and suppliers, the practice of off-invoice charges (“*marges arrière*”) has appeared; this refers to the fact that distributors, since they were more or less compelled by the law to fall in line with a resale price and do not have a practical or commercially competitive margin on this resale price, have sought to regain margins by reselling or themselves selling services to suppliers that are not included in calculating the resale price. This is the practice known as “*marges arrière*”. Ultimately, it means that distributors and suppliers negotiate

twice: first they negotiate the purchase of the product by the distributor and then they negotiate the services that the distributor would provide to the supplier, such as promotional arrangements and marketing campaigns to sell the products placed on the retailer's shelves. This has given rise to dubious practices and to the development of services that are often fictitious, and since distributors, who are often highly concentrated, are in a stronger position than the very large number of suppliers, some very serious abuses have often come to light. Lastly, the aspect of the consensus concerning the benefits to consumers has also been called into question, since the ban has resulted in higher retail prices for consumers once new commercial negotiations have been developed to include payments for services provided to suppliers by distributors. Following the gradual erosion of these three pillars of the consensus in France, an amended version of the law was passed, characterised by its very great complexity. It introduces a system of percentages and advantages that could be deducted from the resale below cost threshold as calculated previously.

According to the French Delegate, the following lessons could be learned from the French experience:

- It is very difficult to argue in favour of the advantages of a system for prohibiting resale below cost. Whenever a regulatory measure is taken, it has perverse or negative effects, which means that one should be very cautious about promoting these kinds of systems.
- Once a country has set up a system prohibiting resale below cost, it is very difficult to change since it affects the structure of commercial relations and afterwards both suppliers and distributors are very reluctant to shift from a structured, regulated system to one in which reselling below cost would no longer be prohibited.
- In France, there are almost no civil cases involving the concept of prohibiting resale below cost; this means that professionals, such as distributors, even though they are attached to this legislation, are very reluctant to initiate civil action when one of their competitors fails to comply with this rule.

In the French Delegate's view, these conclusions shows the need to relax a system of regulation that is largely fictitious in order to give players a clear direction that would ultimately make it possible to eliminate the prohibition against reselling below cost.

The Chairman turned to Germany which seems to have quite a different situation in the sense that the level of RBC is defined differently from what it is in France and seems to be closer to the economic concept of price used in predatory pricing cases. He requested the German representative to explain how RBC is defined in Germany. Also, it seems that the law applies to anybody

who has a “superior market power”, which is short of dominance and, therefore, may apply more widely than to dominant firms. Why should that be legitimate, in other words if you do not have a dominant position if you hurt some competitors but there are no barriers to entry why should one bother with outlying RBC?

The delegate from Germany made 2 preliminary remarks. First, the German retail market is one of the most competitive in the world with the cheapest market price in Europe due to the very aggressive price strategy of the big discount chains like Aldi and Lidl, which are now expanding to the rest of Europe. So an effect-based approach shows that German RBC provisions have not restricted competition in the market. Second remark, although German RBC provisions are assessed very critically by the OECD and other competition agencies and maybe also by some German economists, German consumer associations welcome and endorse these RBC provisions because they think it protects the small and medium sized enterprises to keep them in the market and does not let the market concentration get too high. So views whereby the RBC laws are more likely to harm consumers are definitely not shared by German consumer associations.

The delegate then turned to the chair's first question on the definition of selling below cost price: calculable reductions are deducted directly as cash discounts, rebates and other conditions such as bonuses, including annual ones, advertising subsidies and sales promotion payments and also subtracted from the invoice price to determine the transaction price.

On the second question about the definition of superior market power, legally defined, it's a threshold below the market dominance threshold. It is analysed under the same criteria as market dominance and the most important elements in the assessment are market share, entry barriers, financial strength and the access to supply in the sales market. Typically superior market power is found in narrow oligopolies, and the very large retail chains typically have superior market power as defined by German antitrust law. What Bundeskartellamt does not care about is whether Lidl, Aldi or Walmart make high profit. This is for historical and political reasons that superior market power test exists in the German law: the legislator thought that market dominance is too high to address the problems in the retail market and there is a need to have a threshold below the market dominance to address this problem on the market.

On market entry barriers, theoretically it is possible to establish a shop everywhere in Germany as well as in other countries, but in practice, experience shows that the small shops decrease and that there are few new shops established.

The Chair noted that, according to its contribution, Ireland seems to be in the midst of public debate on whether to abolish its RBC prohibitions, the Groceries Order. Among the several interesting aspects of the Irish contribution, one is the tables and graphs trying to show that there is a direct relation between RBC or resale price maintenance provisions and inflation of prices in particular sectors. He asked the Irish delegation to describe the methodology which was followed to establish this close connection between the price of grocery or food products, and those practices. The second one is a suggestion that there is a very close relationship between prohibition of off invoice discounts and resale price maintenance and coordinated interaction so there seems to be a relationship between diminished horizontal competition and RBC laws. He was curious to know the current state of the debate in Ireland on this issues.

The Irish delegate stated that the RPM concern relates to facilitation of collusion the convenience distribution market where there are several layers of production and distribution. At the bottom there are convenience stores and just above that, convenience distribution. Now in convenience distribution, there is a very high concentration of the market 80% of the market counted for by just two firms, and below a lot of retailers who are essentially price takers from the convenience distributors. The existing rules create a bar against selling below invoice price not below the transaction cost. So the invoice price acts as a kind of information mechanism that helps coordination between the convenience distributors. So the possibility is that RBC laws may be facilitating collusion by making prices very transparent (easy to monitor). The main harm may not be at that level but rather at the retail level because the order prohibits loss leader price competition between retailers. Not just the retail level in the convenience sector is affected, but also the retailers from the supermarket sector, for instance. The Groceries Order prevents large supermarkets from passing on their own discounts to their consumers as well as discounts that they might receive from their manufacturers and so on. There might be an RPM concern in the sense that they are buying branded goods from the manufacturers and selling them on downstream, but there is a floor in place on the price at which they can resell them.

As for the particular table on the different trends in prices for foods under the Groceries Order *versus* other foods, a representative basket of goods was taken – and the information was supplied by Irish central statistics office – for the average household, the cost calculated at the moment and then adjusted to see what the cost of the same basket of goods would have been if items covered by the order had inflated at the same rate as items not covered by the order. There was a clear distinction between the rates of inflation for items covered by the order and those not covered by the order. The gap in prices as

a result of the differing rates of price inflation was about 9% over the reviewed period. So the savings were calculated for an average household per week and it turned out to be about 9-10 euros or so. Annualised that turned out to be almost 500 euros per average household and then aggregated that over all households in the state which is about 1.2 million, it worked out that nearly 600 million euros. This represents a transfer from consumers back to producers. Also the same calculation was made in that table for the different income deciles to demonstrate that it was actually the lowest income decile that was suffering most from the restriction on competition. While the methodology might not be exactly correct in that it doesn't take into account certain price effects that might occur, it's just indicative of the costs to consumers that are arising from the Groceries Order. The numerical calculation helped focus debate on this issue as did a widespread negative consumer sentiment. Against this background, a new national consumer agency was created and a popular TV program called "Rip off Republic" took the figures and invited consumers to send in submissions to their sponsoring department who received about 3 000 or 4 000 submissions. This brought the whole issue to a head and led to the possibility of a removal or at least a modification of the Grocery Act, according to a schedule which at the moment remains unclear.

Chairman said that the Irish situation is quite interesting because it suggests that Ireland should ship a few consumers to Germany to change the mood in Germany! But also in terms of who represents consumers. It was said that the national consumer agency took a stand against this as being adverse to the interest of consumers while in Germany, according to the German delegate, consumer organisations are very much in favour of such laws. There seems to be a little bit of confusion at least across countries on who represents customers by saying what is really in the interests of consumers.

The Chair turned to the contribution of Switzerland which is a different case in the sense that the basis for enforcement of RBC laws in Switzerland is deception of consumers and the justification for the laws is that consumers could be deceived by low prices in some way. It would be interesting if the Swiss delegate could explain exactly what the underlying reasoning is, why consumers would be deceived by the fact that the prices are lower than they would be otherwise. What is the spirit of the law and why is it linked to deception and then of course when it comes to enforcing the law what are the criteria for establishing this deception? What does one have to prove to establish that consumers have actually been deceived by those low prices?

The Swiss delegate said that in the light of the recent political debate on high prices in Switzerland, actually low prices even very low prices are welcome. In terms of the groupings of countries, Switzerland belongs to the category of countries that have removed RBC provisions, in this case by simply by not applying them.

The deception element, it was meant to prevent retailers tricking consumers into buying expensive items by displaying some items at very low prices – consumers might think that because there is one very cheap offer, the other products are very cheap as well, although in fact they are not. Regarding the enforcement question, there can be an assumption of deception if the price charged to the consumer is below the average wholesale price of comparative products.

So deception provision was actually introduced after a hot discussion in Parliament which pitted 2 different groups against each other: one liberalist group and one protectionist group. It appears that the deception provision was introduced to please the protectionist group, but the result actually favours the position of the liberalist group. The reason is that an accusation can be turned aside if either the actual wholesale price was above the average wholesale price **or** if it can be proved that the cheap offer is made transparent to the consumers. For instance, if there is a very cheap offer to make consumers buy in an off-peak period, if the off-peak nature of the offer is made transparent to consumers, then the deception element is not met. The rationale behind this rule is also a kind of consumer protection element but in a different sense than in other countries.

Because this rule has not been applied very often there are no empirical studies about when the deception element is met.

The Chair referred to the Hungarian contribution which described the efforts, apparently unsuccessful, of the Hungarian competition authority to oppose RBC provisions in the agricultural regime that took effect in 2003. Apparently there was a big push to establish RBC provisions following a change or shift in the bargaining position of food processors in their dealings with retailers. So of course that raises the question of whether the competition regime could address this perceived problem through a monopsony or abuse of monopsony inquiry directed by resellers? A second question is whether this provision in the agricultural regime is really consistent with the EU stand on predation which states: “Predatory pricing is a concern not because it harms competitors but because it harms competition”. Is competition lost or are we talking only about the relative situation of competitors on this issue?

The delegate from Hungary replied that in theory the Competition Act could deal with monopsony problems in the context of abuse of dominant position. Of course bargaining power issues which otherwise would not be an abuse of dominant position are not covered by the Competition Act. There were some buyer power or monopsony cases during the 90's but they were cases involving food processing and farmers and not supermarkets or RBC issues. There were some supermarket mergers and cooperation or joint-venture cases regarding supermarkets. Buyer power issues or monopsony

issues were considered in those cases but, in the end, no real problems were found which would have required the authority to block the merger or apply any other remedies. So basically Hungarian experience with cases doesn't support the need for such regulation in Hungary and this is partly why the Authority opposed the RBC prohibition in the agriculture regime.

The Hungarian delegate explained that the Authority has developed quite extended competition advocacy activities to convince decision makers against further RBC laws. The advocacy effort has notably used OECD materials such as a Committee roundtable on buyer power. The Hungarian Competition Authority has been relatively successful so far in its fight against a new wave of RBC regulation in other sectors. The proposal of the new Commercial Act is under discussion in Parliament and in the latest version the proposed expansion of RBC prohibitions was not included. But there are a lot of misperceptions and confusion on this issue right now in Hungary.

The delegate agreed that there was a disharmony between this prohibition and the predatory pricing principle. This is basically not a predatory pricing provision – it is something else. At this point he wondered whether the EU could do some sort of competition advocacy in this field similar to the competition advocacy project which is done in the context of liberalising the professions.

The Chair turned to the Netherlands which is considering adopting a provision on RBC, and where the Competition Authority has been trying to fight like others against this initiative. The Netherlands Competition Authority has undertaken wide ranging European studies on the effect and the administrative issues of enforcing RBC laws. The results are interesting. According to the research, consumers, with the exception possibly of German consumers, have benefited from increased competition between retailers. The number and share of small sized groceries has declined regardless of the presence or absence of RBC laws. The Chair asked the Dutch delegate what are the counter arguments raised by the proponents of RBC who opposed to the study? He also asked what was found in the study that was interesting or surprising?

The Netherlands delegate described first the state of affairs in the Netherlands on this issue. As pointed out, RBC law is nowadays a very politically important topic in the Netherlands because of a very strong price competition going on between supermarkets, which started in 2003. The issue is heavily debated and has received a lot of media attention. There is a strong plea both by the organisations of small and medium sized supermarkets as well as by the big food companies in the food processing industry, to introduce the RBC laws. Last week in Parliament was held a public hearing at which this point of view was communicated by these organisations. Proponents of RBC laws would like to introduce those laws together with the bill to amend the

Competition Act. As indicated in the written submission, the Dutch government is not in favour of such a prohibition on selling below cost price.

Two economic consultancy firms have tried to find a solid economic ground for introducing such prohibitions. They have studied the legal situation in several European countries with RBC laws in place as well as those in countries without. They found – which was a very important conclusion – that in all the countries examined, it's not easy for the small and medium sized supermarkets to keep their position in the market. This is the case in the Netherlands of course, but also in those countries where RBC laws are in place. Another important factor that appeared from the research paper was the likely difficulties in enforcing the RBC prohibition and the effects of these difficulties. In practice it seems quite difficult to enforce such rules in other countries. Compliance with and enforcement will be problematic. In addition it's not simple to determine the purchase price or the cost price when one has to deal with rebates and how those rebates are measured and determined. The Competition Authority will continue to argue that the statutory prohibition of selling below cost price will not solve the problem of the decline of small and medium sized supermarkets, which is the main argument from the food industry sector as well as from the supermarket sector.

On the specific question on insights found, it appears when one looks at the effects of such laws from a comparative perspective that there is no direct effect. In the countries where those laws exist, there is a strong decline as well of supermarkets in suburban as well as rural and urban areas.

On the last question raised by the Chair – the extent or type of rebuttal to the study which the proponents of the RBC laws have developed –, their main counter argument was that according to them, there is a too much focus on reaching the lowest prices possible. In their view, it is in the interest of consumers to have a diversity of products on the shelves in the supermarkets and high service levels. They say : if you balance everything, it is worth it to have a higher price for some products, if in return there are higher service levels and greater diversity of products on the shelves. The competition Authority feels differently: it's up to the consumers to decide whether they prefer a discounter with low prices or a high end supermarket where there is a higher service level and greater diversity of products on the shelves.

In practice in the Netherlands, more and more high end supermarkets appear especially in urban areas; so there will always be a need for high service level supermarkets, so where the consumers indicate that there's a need, those supermarkets will survive.

The Chairman understood the argument of the proponents of RBC not exactly as a rebuttal of the study because if the study finds that the rate of decline of small stores is about the same irrespective of whether there are RBC

laws or not, it would indicate that the variety of products or retail services that consumers get is the same in countries where there are RBC laws and in other countries. But, in any case, it would be quite interesting to see what happens with this debate.

The Chairman continued with Israel where an investigation was started by the Israel Antitrust Authority into whether or not there were RBC sales, and the leading supermarket chain was investigated after complaints from the food processors who wanted to be able to cut off retailers that were reselling their products at a loss. From the Israeli contribution it seems that it was difficult finding a lot of loss leaders. This contribution also tends to establish a relationship between resale price maintenance and the existence or non-existence of laws on RBC. Why is that?

The Delegate from Israel welcomed an opportunity to share a particularly relevant discussion: before flying to Paris, she had a debate with the food producers in Israel, who repeated once more their continuing request to have RBC rules. More generally, the debate over the RBC law heated up when the biggest food retail chain in Israel decided on a new marketing initiative about 6 months ago – it started selling more than 300 products below cost. They said they would do so the whole year round. This caused immediately the 3rd retail chain in Israel to adopt a similar practice; but the 3rd retail chain, which was already in deep financial trouble, after 3 months of adopting this practice, collapsed leaving a debt of over 350 million dollars. This was a big financial loss in the context of the Israeli economy.

The traditional view of the Israeli Antitrust Agency was not to interfere with the loss leader practice. But when the biggest retail chain adopted its new initiative, IAA wanted to see if it was a practice aimed at eliminating small competitors. And it was concerned specifically about the private retail shops that were mavericks in this market. At the end of the examination IAA found no ground for interference and in fact it was the 3rd national retail chain that collapsed and not the small private chains which didn't collapse or even come up to complain to IAA about the loss leader policy that was initiated by the first retail chain. So the Authority had no ground for interference. One of IAA's conclusions was that although there are 300 products that are sold below cost by the 1st retail chain in Israel, one should look at this market as a cluster market, so it is not sufficient to see that the diapers or coffee are sold below cost. What should really be examined is whether the regular cart that is sold by this retail chain is sold below cost – this approach is consistent with defining a cluster market. So of course if someone comes to the retail chain and buy exactly the 300 products sold below cost he will get out with a cart that is sold below cost. But that is not necessarily the outcome in most carts; it may very well be that most of the carts are coming out of the supermarket when they are not sold below cost averagely and we had no indication otherwise.

Since IAA had no indication otherwise it saw no reason to start any initiative of its own.

On the connection between RBC and minimum resale price maintenance, The delegate from Israel explained that in her country it is forbidden to agree on resale price maintenance clause, unless it is specifically approved by the General Director of the Israeli Antitrust Authority or by the Antitrust Tribunal. It could be said that allowing minimum price RPM in some cases and on the other hand forbidding RBC is somewhat of a contradiction, because either one wishes to promote intrabrand competition or one wishes to limit it. RBC rules do not abolish intrabrand competition totally, but they do limit it.

Concerning the 3rd question put by the Chair – when resale price maintenance is allowed? IAA will probably look to see if there are justifications for the RPM such as avoiding free riding or the wish to brand new products that have entered into the market. But IAA will probably not allow RPM on minimum prices to companies that are monopolists (or near monopolists) in their respective markets or where it can shown that they have market power. IAA feels that intrabrand competition is an important form of competition. So coming back to the case of the retail chain, many of the food producers in Israel are indeed monopolists and if they are not monopolists they do enjoy some market power. So should they have come to us with requests to allow retail price maintenance IAA probably would not have allowed it.

The Chair briefly referred to the contribution of Consumers International which was not present for the roundtable. In its contribution CI suggests that the burden of proof be placed on the proponents of RBC laws, in other words they should have to prove that such laws are favourable to consumers both on the diversity of products that the consumers can get and that they don't have any negative impact on consumers. It's an interesting idea which goes back to what was said about the perception of consumers in Germany, and obviously CI seems to have a slightly different view than the consumer organisations in Germany and in other countries, France included.

The Chair continued with Turkey where there is a bill in Parliament on large supermarket stores with one provision which would prohibit among other things 1) the foreclosing of the market by extremely low prices for new commerce and 2) applying short term lower price policy with a view to drive competitors out of the market in the expectation of a long run profit. This wording is slightly ambiguous and it is vaguely reminiscent of predatory pricing laws, but not quite the same.

The Turkish Competition Authority has waged a battle against this type of provision and also seems to have been reasonably successful in its advocacy effort against this. The chair asked the Delegate from Turkey to tell the Committee why there is this debate in Turkey? Is it limited to the food sector?

Did it originate in the food sector and if so why? What is the state of play? What is the current state of play with the bill?

The delegate from Turkey described the situation of the large retail superstores in his country, which were under fire from 2 different sides: from the small food producers who were complaining about large retailers' buying power and from the small grocery stores which insisted that they could not compete against those large retail stores because they were able to finance RBC sales. However the Turkish Competition Authority has undertaken together with the World Bank and the Union of Chambers and Stock exchanges of Turkey a comprehensive study which covers the so-called fast moving consumer goods – a basket of 150 to 200 goods involving food, cleaning and other types of goods with very limited shelf life. According to the result of the survey, food and personal care cleaning products in the basket, have been 3 to 4% more expensive in grocery shops than in the discount outlets and large retailer chains. With respect to price data on personal products, the grocery shops were again relatively more expensive by 1 or 2% on average. Cleaning products were found to be prices at roughly the same level in different types of stores. The price research also shows that there are significant geographic price differentials for items in the basket of products. It was about 14 to 15% in all products or baskets considered in 2004. Since there are quite thin profit margins in the retail sector, this price differentiation is quite significant. The study found that consumers were fairly price sensitive in food products especially.

The large discount store chains and local supermarkets have increased their market shares for all consumer categories whereas the smaller grocery shops have lost substantial market share in the last 5 years. The large retail stores and large supermarkets with sales areas exceeding 1 000 m² are approximately 21% of the retail market as a whole as of 2004. There are price deductions undertaken by these large stores usually done through promotions at least once a month. Small retailers adjust prices more frequently to respond to the pricing policies of those large retailers, but the competition takes place in the local market in the first instance. The location problem is one of the problems that the draft bill has tried to address. The government tries to take those large retailer chains out of towns and it brings severe pricing regulations on them, regulating their promotions and other discount sales activity. The Turkish Competition Authority has argued against a separate law. The competition law already exists and should be enforced.

For the 3rd question, the draft bill is still being examined by various state bodies and it is still unclear what will be the outcome, but TCA maintains its position opposing new RBC provisions.

The Chair noted that it's becoming increasingly clear through the contributions that the consumers do not understand that Competition Agencies are in their favour, bringing them this surplus. Competition Authorities seem to have a massive communication problem that extends to businesses as well as to final consumers.

The Chair asked the US delegation about state RBC laws. The US contribution observed that the RBC issue arises not just in the food sector, but also in gasoline and cigarettes. What is the relationship between milk, cigarettes and gasoline that you can see? Why is it particularly in those sectors that those laws seem to be more prevalent? The second question related to the argument whereby this is an issue for the States when the US is the country of the world where the competition culture is the most developed, where the power of the antitrust authorities and the power of advocacy as well is the most developed. The third question is do those laws provide for the possibility for a retail shop which wants to meet the competition from a bigger store to resell below cost or is there a *per se* prohibition, and how strongly are these laws enforced by the states?

The US Delegate (US DOJ) explained that in the US about 40 of the 50 states have general RBC laws, some kind of specific RBC law or both. 16 states have a specific law relating to cigarettes and six of them do not have a general law. 14 states have a specific law relating to gasoline and 8 of them do not have a general law. The reason why so many states have specific laws relating to gasoline is that they are not there to protect consumers but to protect small businesses. In the gasoline industry in the US there are a very large number of independent retailers. They may carry the brands of the major companies, but they are independent businesses. They have a well organised lobby to protect their interests --which is in limiting competition from low price gasoline stations. In particular, over the last quarter century, refiners have established high volume, company-owned stations that provide no repair services or anything like that, may have convenience stores but many of them, or may be gasoline only operations with high volumes and very low margins. These refiner-owned stations can make it difficult for the small businessman to make a living.

For cigarettes, the case is not quite as easy to understand. There are a large number of small convenience stores in the US. Cigarettes are a major source of revenues for these stores; in addition cigarettes are products that bring people into the stores. It is not clear how well organised the small store lobby is or why they think they are particularly threatened on cigarettes *versus* other products they carry.

As for advocacy, traditionally the Department of Justice has done very little advocacy at the state level, a fair amount has been done in recent years

on the unauthorised practice of law situation. The Federal Trade Commission however has been very active in competition advocacy at the state level and very active in this area in particular.

The US (FTC) representative continued discussing advocacy against state RBC laws saying that this is an area where the FTC has been involved to a much greater degree than the Department of Justice. At its core, competition advocacy is about representing consumers in the political system. Due to consumers' relatively high costs of political action, consumer interests are underrepresented in relation to industry interests when policies are formed. Competition provides consumers with lower prices, higher quality, and greater variety. Thus, by promoting policies that allow market forces to work to the greatest degree possible – as opposed to protecting certain industries from competition – competition advocacy promotes consumer welfare. The FTC's ability to influence states' policy decisions depends on a variety of factors. For example, success appears to be positively related to there being an effective and organised interest group already in place that is supporting the FTC position. The US DOJ representative spoke about how well organised the independent gas station owners' lobby is at the local level. Although very large stores are well represented at the national level – the RBC laws are often enforced against the “big box” stores like Wal-Mart and Costco – at the local level, these stores often have less political influence than the independent gas stations.

It is important to let consumers know that these laws are harming them. If there is an organised group in place, it often has local press contacts who can write stories on the topic, which inform consumers and ultimately help to put pressure on the politicians that are considering these laws. Additionally, it is helpful if the executive branch of the state is supportive. Generally, the State Attorneys General Offices, especially those in charge of enforcing competition laws at the state level, have views similar to those of the FTC – that RBC laws are bad for consumers. Whether there is already an RBC law in place also will make some difference in the probability that competition advocacy will be successful; it is more difficult to change the status quo than to oppose a bill that is going to impose an RBC law.

On the meeting competition defence, the US delegate said it is not clear how common this defence is for RBC laws. The Robinson-Patman Act allows the defendant to raise this defence as long as the defendant has a “good faith” belief that they are meeting competition. RBC laws, on the other hand, typically impose a higher evidentiary requirement on defendants claiming this defence. A business usually must have some sort of document or written evidence; for example, a journal that shows in the normal course of business, one kept track of competitors' prices and could show on a specific day that this competitor indeed was charging this price and in order to match it the

defendant had to charge a below-cost price. Another thing with the application of the meeting competition defence in a below cost sales law is that it is not legal to meet a below cost sale with a below cost sale, because this will lead a “chicken and egg” sort of problem where one person sells below cost and the other stations sell below cost, setting off a chain of below-cost sales. That sort of exception, in practice, would eviscerate the law – a state authority would have to untangle everything to figure out who set off the chain. In fact something similar to this happened in the state of Maryland this summer, where one discounter began selling below cost and that set off a chain until one service station decided that it did not want to sell below cost. Accordingly, it called the state authority, which made the gas stations raise their prices to conform to the statutory requirement.

The Chair then gave the floor to Greece and BIAC.

The Greek Delegate reported that the Greek Competition Authority has recently dealt with a case directly relevant, as it is a good example of how the enactment of RBC law can provoke anticompetitive pricing behaviour by firms in the retail grocery sector. The case drew great media publicity and the intervention of the Hellenic Competition Authority gained the support of the consumers.

In Greece, the retailers cannot sell below their invoice cost that is the purchasing price on the invoice, plus all the taxes and transportation costs and less all the invoice discounts. This forms a sort of mandatory RPM, but it doesn't necessarily affect the freedom that the supplier and the retailer have to bilaterally negotiate and agree on the percentage of the invoice discount according to the size and the volume of sales of the retailer. The legislation was enacted in 2001 just a few months before the introduction of the Euro. At that time it was the result of a successful lobbying of the association of retail stores chains and grocery industry to the Ministry. The Minister at that time was very worried about future price increases in view of the introduction of the Euro; that's why after the enactment of the law he entered into a gentlemen's agreement with the association of retailers and the association of the food industry. They all agreed to include in the invoices all the excessive amount of discounts and offers that the suppliers at that time grant to the retailers and they were going to pass this discount on to consumers.

In this context, the board of the association of retailers took the initiative to draw up a list where it fixed the exact amount of discount that each food industry separately had to grant to all of its members. The amount of discounts was the same for all retailers and they didn't vary according to the size or the volume of sales of the retailers, so they were fixed percentages of discount. Then the association of retailers circulated this list by way of a recommendation to all of its members and asked for its implementation. The

Hellenic Competition Authority investigated this case in 2004. It came to the conclusion that this list constitutes a decision that has as its object indirect price fixing and that's why it infringes national legislation as well as article 81 of the treaty. The fine that was recently imposed in July 2005 on the association of retailers amounted to 15 million euros, that is a record fine for the Greek standards, and now, of course, the case is under appeal. The retailer association argues that they complied with the legislation and with the gentlemen's agreement with the Ministry and now it's up to the Court to decide whether that's true or not.

The representative from BIAC introduced his remarks stating that from a competition point of view, laws which are designed to prevent businesses from offering the lowest prices they can possibly offer are counter intuitive. Low prices are almost always good for consumers and the prohibition to charge particularly low prices, i.e. prices below cost should be regarded with a high degree of scepticism. Last year's roundtable on predatory foreclosure has shown that the prohibition of predatory pricing by dominant undertakings properly drafted and applied may be very useful or even necessary mechanism to prevent consumers from being harmed by abusive low pricing strategies. The example the Israeli representative just gave is a very telling one with respect to the difference between the 2 concepts. RBC laws go beyond the prohibition of predatory pricing in various respects. RBC laws raise the floor on the pricing that a dominant firm can undertake above the predation standard. They also often apply to non-dominant firms which are not subject to the abuse of dominance standard (Germany; France, Belgium are examples). And finally RBC laws simply prevent firms from offering low prices without requiring any evidence of a negative impact on competition or consumers. In most cases RBC laws are drafted as *per se* restrictions and as such are rather blunt and unsophisticated instruments.

The last aspect is probably the most troublesome. *Per se* rules can only be justified in situations where the negative impact of a certain practice is clear. If there is no evidence of negative impact of RBC on competition or consumers, consumers arguably benefit from below cost pricing strategies. From the Dutch research it seems that there is no evidence for a negative impact. The Secretariat's background paper quite rightly describes the significant number of situations in which it may be perfectly reasonable for firms to engage in below cost pricing strategies. The introduction of new products or the arrivals of new entrants into an established market are but 2 examples. In these circumstances RBC laws are likely to harm consumers by denying them the low prices resulting from loss leader strategies. At the same time they are likely to protect inefficient competitors. This is not only true for RBC laws of general application, i.e. laws applying to all retail merchandise. They are also examples of RBC laws covering the sale of specific items such as fuel and

petroleum products (i.e. the US example – cigarettes and other products). In many cases, the economic sectors concerned are not exactly newly liberalised industries where RBC laws may attempt to give new inefficient commerce some temporary protection to allow them to reach viable scale. It's more or less the result of a lobbying exercise in many cases. Quite often the explicit purpose of such laws is to protect smaller competitors. This obviously comes at a price for consumers as pointed out in the Secretariat's background note as well as in the BIAC paper, and the Irish Competition Authority has recently estimated that removing RBC restrictions, (restrictions imposed by the grocery order), would have saved an average household up to 500 euros over 12 months. This is an enormous amount of money and looking at the damage, even if it's only 200 euros, this is a very serious amount of money, and comparing this to the damage done by cartels it's not easy to tell the difference. Again the key issue is whether there is evidence that the strategies prohibited by RBC laws such as the grocery order have a negative impact on the consumers or competition as such. That is of course not the same as a negative impact on individual competitors. In the absence of such evidence RBC laws are likely to harm consumers. The Irish example shows that RBC laws should be monitored and assessed as to whether they actually deliver benefits to consumers and to competition as such, in particular where there is a parallel prohibition abuse of dominance by predatory pricing. With respect to new projects for RBC laws it might be worth thinking about shifting the burden of proof regarding the impact of such laws to those constituencies who would benefit from the introduction of RBC laws. It seems that the positions of consumers and the business community are very much in line on this issue and that RBC laws are more likely to harm consumers than to benefit them.

Chairman wondered what the representation of the agro food sector is in BIAC.

The delegate from Italy commented in stating that an additional effect of sales below cost laws is that they tend to increase collusion, they reduce rivalry among suppliers as well, which is quite an important effect and in particular because without the law when a supermarket sells something at a very low price, rivals do not know whether that price is below cost or not. Therefore, they tend to compete more aggressively to get the manufacturer discounts to that supermarket as well. This is why in many countries including in Italy, manufacturer associations and especially branded goods manufacturing associations are quite in favour of RBC laws. Nobody says of course that below sales cost law reduces rivalry. What they say is that sales below cost reduce the degree of reputation of their high quality products, which should be perceived as high quality by consumers. These products are sold at very low price reducing thus the image and the reputation of this product that they have so strongly built through advertising. According to this view, the RBC laws are important for keeping up that reputation and making such investments

worthwhile. These arguments are pushed aggressively on the part of the manufacturing sector and of the retailers.

The delegate from The Czech Republic described the situation in his country, which is characterised by a significant concentration of supermarkets. Almost 70% of goods in the Czech Republic are sold in supermarkets located in historical centers of towns with small shops going bankrupted. More than 90% of the production of food is sold in supermarkets and this has triggered a very strong problem between producers of food and supermarkets. A special law about economic dependency is under discussion in Parliament, which should prevent the destruction of the Czech agriculture and the Czech food producing industry.

The Chairman said that in France such a law on abuse and dependency exists. It has turned out to be rather disappointing for everybody for people who are competition prone but also for the lobbies who were in favour of this. There are several types of issues, one of them is to define dependency; the second one is to find remedies and the third one is the fact that when there is in fact a situation of dependency however that's defined, it's very seldom that the dependent agent will complain because he worries about retaliation.

The European Commission representative responded to the Hungarian delegate's request to see the EC doing some advocacy against RBC laws. The EC has tried to tackle this issue not from the perspective of its antitrust authority but from the perspective of the rules in the EU treaty about free movement of goods between member states. There's some case law which dates from around 1990-91 where the Court of Justice of the European Union declared – and the Commission intervened in that sense in the proceedings – that these kinds of laws, the RBC laws, were against EU rules on free movement of goods even if the law didn't discriminate between products of different member states, national products or products from other member states. Unfortunately, a couple of years later in 1993-94, the Court of Justice of the EU reviewed these decisions and decided that these kinds of laws were not against the treaty, they didn't discriminate between national products and products from other member states.

If the EC could do some advocacy from the field of antitrust (from the field of Director General of Competition), it's probably difficult to tackle this issue because EC provisions don't provide necessary acts with appropriate legal basis, but it is worth exploring the possibilities.

The delegate from Brazil drew from the discussion the conclusion that probably the key is not the legal and academic research about why this is bad and welfare reducing but really it seems to be advocacy and referred to 2 very particular issues about Brazil that clearly point to the importance of advocacy.

Brazil doesn't have any RBC or RPM kind of law. According to him, the reason is the competition situation in the retail sector between the large and

the small retailers: the small retailers by not paying taxes compete on an unfair basis with the large retailers; and if there was an RBC law one would have to look into how much is actually being paid for the goods not only on the invoice but also on taxes and so forth. Such a law could potentially be used in favour of the large supermarkets against the small ones so that's why the small ones aren't pressuring the government to put in place such legislation.

He made another point in saying that in Brazil consumers do clearly understand the value of not having this kind of law and reported the following anecdote. 2 years ago in the city of Sao Paulo the municipal government implemented a system whereby one could use the same bus tickets for as many as four different rides within a period of 4 hours to make it easier for people to commute, especially poor people. Right after this new bus ticket was implemented, 2 different people going to work looked at the supermarket newspaper inserts with loss leader announcements from different supermarkets comparing prices and then using the fact that they could jump off the bus at different points on their way home, jumping off at one supermarket chain, buying the loss leaders in that place then taking the bus again with the same ticket, then jumping off at the second place on the way home and buying the other loss leaders! So they were showing extreme price sensitivity because of income problems; consumers understand these things, they get the signal.

Also, in many supermarket chains in Brazil right at the entrance there are two carts that are the average baskets consumed by the people who frequent those supermarkets and one will show: "Don't be fooled by the loss leader announcements! This is what your average purchase is going to cost you here, and this is what it'll cost at the competitor's which is down the street". So the cluster idea is being taught to consumers by the supermarket chains and they get it. This points clearly to the fact that it's not about having consumers to understand the concept or having the right arguments on a theoretical basis, but it's really how to get to the consumers and get them organised so that the real average consumer does have a voice in the process to avoid the lobby by the special interest that would be favoured by this kind of law.

Another delegate from Brazil reacted to the barriers to entry comment made by the delegate from Germany. There are a lot of cases to illustrate that in Brazil barriers to entry in supermarkets were overvalued because after the merger or during the merger analysis there were entries. Surprisingly what happened was that the average price of the food declined; the people were very concerned about the merger wave because they thought that if the smaller business went out the prices could go up. This did not happen, but most interesting, after this merger there was an increase of the independent supermarkets, medium supermarkets in most of the towns. The traditional stores increased in number although they had declined in market share and also the independent supermarkets in some regions have been a lowering

prices more than the big chains. It appears that the food industry are putting in place a lot of strategies to maintain alive the medium retailers giving them discounts equal to the net price they offer the bigger retailers. So the fringe of competitors in retailer can survive because the food industry transfers to them some discounts. It is important to pay attention not only to discounts but other strategies that are in place in the retailing and food industry especially in developing countries where food prices are so important relative to income. If the German consumer can afford to have higher prices it's ok, but it's not possible in countries like Brazil.

The Chairman returned to the Czech Republic delegate to clarify the point he made. Is the problem in the Czech Republic really a problem of sales below cost or is it a problem of the fact that the large market chains do not necessarily sell below cost but have lower costs because they buy on the international market as opposed to buying locally, and that creates a difficulty for the small retailers? As he understood his explanation, there was a difficulty for the small retailers but the delegate seemed to imply that the supply of the large market chains could come from outside the country and, therefore, was cheaper than what was locally produced. Is that where the problem is? If that's the case it may indeed be an important issue both sociologically and politically and possibly even economically in trying to organise a transition but not necessarily something which is directly what the Committee is talking about in the RBC sense.

According to the Czech delegate the main problem in his country is that the purchasing power of supermarkets against the producers of food is extremely high. The prices for the producers are lower and lower and Czech producers are going bankrupt. There is no abuse of dominant position since there are 15 big networks of supermarkets in the Czech Republic, and there aren't any cartel agreements among them, although they behave the same.

The Chairman concluded the roundtable by noting that one of the important things that came out of the discussion was the fact that there have been some systematic studies on the impact of those laws both to try to show that the assumed benefits by the proponents do not necessarily show up and also showing that some of the costs to the consumers are probably much higher than one thought, and this is possibly one of the best answers. However, the Chairman felt, there may be other issues, worthwhile revisiting in the future such as the issue of buyer power. Maybe one should also consider that what one is up against is very often groups that get displaced very rapidly, and there is a social issue which is the reason why the lobbying by those groups is so powerful. And certainly the Committee has lessons to learn about how one advocates effectively because this seems to be a relatively clear case where there is unanimity of thoughts on the fact that those laws are just unsound, they don't solve the problem that they are supposed to solve and they cost a lot.

Resale below Cost Laws and Regulations

4. Country Contributions

Further information from the following jurisdictions on the topic of Resale Below Cost laws and Regulations is available at: www.oecd.org/competition under the topic “Best Practice Roundtables”.

Country contributions

France	Turkey
Germany	United States
Hungary	Israel
Ireland	BIAC
Japan	Consumers International
Netherlands	
Switzerland	

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